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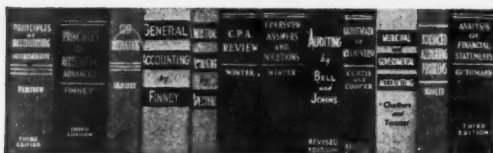
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EMANUEL SAXE, *Managing Editor*

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No. 10

Relief Under Sec. 721 and How to Get It

By PAUL D. SEGHERS, C.P.A.

THE possibilities of Sec. 721 in obtaining excess profits tax relief in meritorious cases apparently has been neglected to a considerable extent by many accountants and lawyers. The purpose of this article is to summarize the provisions of Sec. 721 and to suggest methods of establishing the right to relief under that section, in the light of recent favorable Tax Court decisions.⁽¹⁾

The discussion of this subject will be presented under these seven headings:

1. Purpose and nature of relief under Sec. 721.
2. Computation of "net abnormal income."
3. General rules for apportioning "net abnormal income" to years other than the taxable year.
4. Apportionment in the case of the

six classes of "abnormal income" specified in Sec. 721.

5. Computation of tax under Sec. 721.
6. Procedure in claiming relief under Sec. 721.
7. Leading decisions of the U. S. Tax Court in Sec. 721 relief cases.

1. Purpose and Nature of Relief under Sec. 721

Sec. 721 was enacted in order to afford relief from the extremely high taxes on excessive profits in the case of income attributable to activities or events in previous or subsequent years⁽²⁾, but realized, for income tax purposes, in the taxable year. This may include income derived by manufacturers from the development of new products and processes.⁽³⁾

Relief is afforded under Sec. 721 by computing the tax liability in the following manner:

That portion of the taxpayer's "net abnormal income" realized in the taxable year which is attributable to other years is excluded from gross income of the taxable year⁽⁴⁾, and

Excess profits tax is computed on income so reduced⁽⁴⁾, and

PAUL D. SEGHERS, C.P.A., and a member of the Society, is the founder and a past president of the Federal Tax Forum. He was chairman of the Society's Committee on Federal Taxation and is a member of the corresponding committee of the American Institute of Accountants.

(1) See Part 7 of this article; and "Manufacturers Can Get Relief" by the same author, TAXES, June, 1946.

(2) H.R. Rep. No. 146, 77th Cong. 1st Sess. (1941), 1941-1 Cum. Bull. 550,556. Sen. Rep. No. 2114, 76th Cong. 3rd Sess. (1940), 1940-2 Cum. Bull. 528.

(3) Sec. 721(a)(2)(C), I.R.C.

(4) Sec. 721(c)(1), I.R.C.

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The tax liability so computed is increased by the aggregate increase, if any, in *excess profits tax* that would have resulted had such excluded income been included in gross income in the previous years to which attributable⁽⁵⁾, and

The portion, if any, of such excluded income which is attributable to future years must be included in gross income for such future years, for *excess profits tax purposes*⁽⁶⁾.

The resultant tax liability is subject to the limitation that the additional excess profits tax computed in the above manner for previous and subsequent years with respect to such excluded income shall not result in subjecting the taxpayer to a greater aggregate amount of excess profits tax than would have been due without the application of the provisions of Sec. 721.⁽⁷⁾

Sec. 721 has no effect on the computation of base period net income.⁽⁸⁾

Sec. 721 has no application in the computation of any tax other than the excess profits tax⁽⁸⁾ (except to the extent that the amount of the excess profits tax or the credit under Sec. 26(e) is a factor in the computation of other taxes).⁽⁹⁾

The *exclusion* from gross income of the taxable year of income attributable to other years under Sec. 721 does not enter into the computation of the carry-over of net loss or unused excess profits credit from such year.⁽¹⁰⁾

The attribution of such income to other years may, however, affect the amount of carry-over of net loss or

unused excess profits credit from such years, for the purpose of computing the excess profits tax liability or increase in such liability for such other years, or for the taxable year.⁽¹⁰⁾

The effect of the above-described computations of tax under Sec. 721 is such that a manufacturing concern, for example, that has realized increased income in one or more of the excess profits tax years as a result of its development of products or processes, may be entitled to substantial refunds of excess profits tax under Sec. 721. If such development was completed prior to 1940, the portion of the "net abnormal income" of the taxable year that is to be attributed to other years under the provision of Sec. 721 (see Part 3 of this article) will all be attributed to years prior to 1940. Hence, all such income will be altogether free from excess profits tax, since there was no *excess profits tax* (as that term is used in the Internal Revenue Code and in this article) in those years. The necessarily complex provisions of Sec. 721⁽¹¹⁾ relating to the effect of attributing income to future years have no application to a case such as described in this example.

2. Computation of "Net Abnormal Income."

In order to qualify for relief under Sec. 721, a taxpayer must establish that it has "abnormal income" in the taxable year and that a part of this income is attributable to other years.⁽¹²⁾ "Abnormal income" is defined in Sec. 721 (a)(1) as income of *any one class*, the aggregate amount of which in the

(5) Sec. 721(c)(2), I.R.C.

(6) Sec. 721(d), I.R.C.

(7) Sec. 721(d)(1), (2) and (3), I.R.C.

(8) Sec. 721(e), I.R.C.

(9) Sec. 26(e), I.R.C. and Reg. 112, Sec. 35.721-3.

(10) The definition of the "unused excess profits credit" contained in Sec. 710(c)(2), which in turn is based on the definition of excess profits net income in Sec. 711(a), does not provide for any adjustment on account of net abnormal income as defined in Sec. 721. In attributing income to other years, however, the attributed income is included in the gross income of the taxpayer for that year, for excess profits tax purposes, and, hence, may decrease a net loss carry-over or unused excess profits tax credit. (See Reg. 112, Sec. 35.721-3 and -4).

(11) Sec. 721(d) and (e)(3), I.R.C.

(12) Sec. 721(c) and (a)(3), I.R.C.

Relief Under Sec. 721 and How to Get It

taxable year is in excess of 125% of the average of income of the same class for the four preceding taxable years (or for years taxpayer was in existence, if less than four). It is immaterial whether or not such income is actually abnormal in nature.

The classification of income is subject to the provisions of Sec. 721(a)(2), which prescribed six specific classes of income. (See the description of each of these classes in Part 4 of this article). If income is classifiable under more than one of these classes, the taxpayer must irrevocably elect one.⁽¹³⁾ Classification of income *not* within one of these six classes must be in accordance with the Regulations,⁽¹⁴⁾ which provide in general that the classification must be reasonable for the taxpayer's type of business; must be appropriate in the light of the taxpayer's experience and accounting practice; must be consistent with classification made in applying Sec. 722, or 711(b)(1)(H), (I), or (J); and that such classification is subject to approval by the Bureau upon examination of the return.

"Net abnormal income", as defined in Sec. 721(a)(3), is "abnormal income" of any one class less the sum of:

- (1) 125% of the average amount of gross income of the *same class* for the four previous taxable years (or the previous years the taxpayer was in existence, if fewer than four) and
- (2) A proportionate part of any direct costs or expenses (other than costs deductible in arriving at gross income) through the expenditure of which such abnormal income was in whole or in part derived, computed in accordance with the formula

prescribed in the statute and illustrated in the Regulations.⁽¹⁵⁾

In computing the average amount of income of any *one class* for the test period, the aggregate amount for such period (the four previous years, or less, as the case may be) is to be divided by the number of taxable years in such period, even though some of such years consist of less than 12 months, and even though there was no income of the same class in one or more of such taxable years.

3. General Rules for Apportioning "Net Abnormal Income" to Other Years.

Having computed the amount of "net abnormal income", the next problem is to determine what portion of this "net abnormal income" is to be attributed to prior years. The Regulations⁽¹⁶⁾ provide that "net abnormal income" must be allocated to the various *items* included in abnormal income, in order to determine the portion of each such *item* attributable to prior years. These "items of net abnormal income are to be attributed to other years in the light of the events in which such items had their origin, and *only in such amounts as are reasonable* in the light of such events." The segregation of any one class of abnormal income according to "items" is unnecessary, unless some such items (of the same class) are to be attributed to other years in varying proportions.⁽¹⁷⁾

The rules for attributing income to other years, prescribed in the Regulations with respect to each of the six classes of abnormal income specified in Sec. 721(a)(2), are given in the next part of this article. In order to establish the amounts of net abnormal income attributable to other years, it is necessary to make a positive show-

(13) Sec. 721(a), I.R.C.

(14) Sec. 721(a), I.R.C. and Reg. 112, Sec. 35.721-2.

(15) Sec. 721(a)(3), I.R.C. and Reg. 112, Sec. 35.721-1.

(16) Reg. 112, Sec. 35.721-3.

(17) See the method of computation prescribed by the Tax Court in place of those stipulated by the parties, in *Knight Machinery Co.*, 6 T.C. 519, as detailed in "Manufacturers Can Get Relief," note 1, *supra*.

ing to satisfy the negative tests prescribed in the Regulations.⁽¹⁸⁾ These lay down the rule that items of net abnormal income of the taxable year shall *not* be attributed to other years to the extent that they result:

- (1) from high prices
- (2) from low operating costs
- (3) from increased physical volume of sales *due to* increased demand for, or decreased competition in, the type of product sold by the taxpayer
- (4) from an increase in the amount of such income in the taxable years over the average for the previous years *solely* because of an improvement in business conditions, or
- (5) *solely* by reason of an *investment* by the taxpayer in assets, tangible or intangible, employed in or contributing to the production of such income.

In the case of income of the class defined in Sec. 721(a)(2)(C), that is, from exploration, discovery, prospecting, research, or development of tangible personal property, patents, formulas, or processes, or any combination thereof, extending over a period of more than 12 months, if such income is taken into account in determining base period net income under Sec. 722, then only such portion of such income shall be deemed attributable to another taxable year as is attributable to an excess profits tax year.⁽¹⁹⁾ This provision eliminates "overlapping" of Secs. 721 and 722 as to income of this one class attributable to the base period and years previous thereto.

If in any future year the taxpayer transfers substantially all its properties or distributes any property in complete liquidation, income otherwise attributable under Sec. 721 to subsequent

taxable years shall be included in such future year, or the year of realization of such income, whichever is later.⁽²⁰⁾

4. Apportionment in the case of the Six Classes of "Abnormal Income" prescribed in Sec. 721.

The Regulations prescribe rules with respect to the attribution to other taxable years of items of net abnormal income of each of the six classes specified in Sec. 721(a)(2). Each class of abnormal income will be described below and comments will be presented on the Regulations applicable to each class.

- (a) "Income arising out of a claim, award, judgment, or decree, or interest thereon." Sec. 721(a)(2)(A).

The Regulations⁽²¹⁾ point out that all such income must be considered as a single class. This seems in conformity with the unambiguous language of the statute, although it is doubtful that Congress intended to consider all income of this class normal in nature merely because more than one item of such class was received during a five year period.

Generally, where claim arises out of exploitation, removal, or use, income will be attributed to years in which such events occurred, taking into consideration, for example, the number of units produced or removed, in each year. (Where interest is included in the amount recovered, effect is to be given to the time factor in allocating such income to the years to which attributable.)

- (b) "Income constituting amounts payable under contracts, the performance of which required more than twelve months." Sec. 721(a)(2)(B).

(18) Reg. 112, Sec. 35.721-3.

(19) Sec. 721(f), I.R.C.

(20) Sec. 721(b), I.R.C.

(21) Reg. 112, Sec. 35.721-6.

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(This classification is not applicable to taxable years beginning after Dec. 31, 1941. See the provisions of Sec. 736, noting especially their elective retroactive effect.)⁽²²⁾

Only the period beginning with the commencement of the work and ending with its completion is to be taken into account.

Generally, this provision is applicable only if taxpayer used completed contract basis for income tax purposes, and then only for years beginning prior to January 1, 1942).

Such income shall be attributable to the years during which *expenditures* were made, in proportion thereto, taking into account inventories of unused materials and supplies. (Note that this is *not* the same as the "percentage of completion" method.)

- (c) "Income resulting from exploration, discovery, prospecting, research or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months." Sec. 721(a)(2)(C).

This is by far the most important and most common class of income with respect to which manufacturers and patent licensors, as well as producers of minerals, oil, gas and other products, may be entitled to relief under Sec. 721.

The Regulations⁽²³⁾ state that the activities resulting in income of this class must be those of the taxpayer and not of a predecessor. Note, however, that

the Regulations give an example of relief afforded a taxpayer that purchased an invention and then made further developments.

The Regulations⁽²³⁾ provide that "if the taxpayer engages in *manufacturing*, marketing, mining, oil production, or similar activities, only such *portion* of the resulting income as is attributable to exploration, discovery, prospecting, research, or development is within the class of income described in this section." The statute does not specifically require any reduction in relief such as is implied by this sentence in the Regulations. Neither do the cases so far decided by the Tax Court under Sec. 721.

The Regulations⁽²³⁾ provide that *items* of net abnormal income of this class are to be attributed to the years during which *expenditures* were made for the particular exploration, discovery, prospecting, research, or development in proportion to the amount of such expenditures. The Tax Court has applied this rule,⁽²⁴⁾ while indicating that it is not necessarily to be applied in every case involving income of this class. It is immaterial how such expenditures were accounted for by the taxpayer in its books and returns. It is, therefore, essential to show the amount of all such expenditures on account of each item of such income, for each year of the period of the taxpayer's development of the product, process, etc.

It is also necessary to show the amount of all direct "costs" or expenses deductible in the taxable year (in general, sell-

⁽²²⁾ Reg. 112, Sec. 35.721-2 (last sentence) and Reg. 109, Sec. 30.721-7.

⁽²³⁾ Reg. 112, Sec. 35.721-7.

⁽²⁴⁾ Knight Machinery Co. (note 17, *supra*) and Rochester Button Co., 7 T.C. No. 65 (See Part 7 of this article).

ing expenses in the case of a manufacturer) through the expenditure of which the income of this class was in whole or in part derived. The cases sanction determining such amount in the ratio of the income of this class to the taxpayer's total gross income for the taxable year.

It is necessary to establish the aggregate amount of all gross income of this class, for the taxable year and for each of the four previous taxable years.

The cost of goods manufactured must, of course, be deducted from sales in arriving at gross income.

In order to establish the amount of each item of net abnormal income of this class that may be allocated to years other than the year of realization, it is necessary to show the extent, if any, to which the increase in such income in the taxable year over the four previous years is *not* to be so allocated because of any of the events or conditions enumerated in Part 3 of this article. Any portion of the net abnormal income of the taxable year attributable to any such events or conditions is to be deducted,⁽²⁵⁾ and only the remainder, if any, is to be allocated to the years during which the development, etc., was carried on by the taxpayer.

- (d) "Income includible in gross income for the taxable year rather than for a different year by reason of a change in the taxpayer's accounting period or method of accounting." Sec. 721(a)(2)(D).

The Regulations⁽²⁶⁾ give as

an example a change from the installment method to the accrual method (but see Sec. 736, affording special relief to taxpayers using the installment method provided by Sec. 44).

Other changes in accounting method might include change from cash to accrual basis, "completed contract" to "percentage of completion" method, etc. (But see 721(a)(2)(B) above and Sec. 736, as to income from long-term contracts.)

It would seem that only under exceptional circumstances would relief be obtainable under the provisions of Sec. 721 in the case of a change of accounting period. No light on this point is afforded by the Regulations or published rulings and decisions.

- (e) Income derived by lessor of real property upon termination of lease. Sec. 721(a)(2)(E).

The first example in the Regulations⁽²⁷⁾ — income from acquisition of improvements — is applicable only to years beginning prior to January 1, 1942, in view of Sec. 22(b)(11). Rules are given in the Regulations for attributing the income to the proper years under various circumstances.

In case of a lump sum received for cancellation of a lease, the Regulations provide that the income is to be attributed ratably to the years that otherwise would have constituted the remaining life of the lease.

- (f) Dividends on stock of foreign corporations other than foreign personal holding companies. Sec. 721(a)(2)(F).

As pointed out in the Regu-

⁽²⁵⁾ See Knight Machinery and Rochester Button cases (notes 17 and 24 supra).

⁽²⁶⁾ Reg. 112, Sec. 35.721-8.

⁽²⁷⁾ Reg. 112, Sec. 35.721-9.

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lations,⁽²⁸⁾ this provision has no effect where the invested capital method is used, except as to dividends on stock that is not a capital asset.

Such dividend income is attributed to the years in which were accumulated the earnings and profits from which distributed, if accumulated *after* the acquisition of the stock by the taxpayer.

If distribution is out of accumulations prior to acquisition of the stock by the taxpayer, such income is to be attributed to the year of acquisition.

The earnings and profits out of which any distribution is made are those most recently accumulated, as provided in Sec. 115.

5. Computation of Tax under Sec. 721.

The excess profits tax for the taxable year, computed under Sec. 721,⁽²⁹⁾ is the sum of:

- (a) The excess profits tax on the excess profits net income of the taxable year after exclusion therefrom of the aggregate amount of all items of net abnormal income attributable to other years PLUS
- (b) The aggregate of any increase in excess profits tax which would have resulted if there had been included in the gross income of each previous taxable year the aggregate of all such items of net abnormal income attributable thereto.

In computing the tax for future tax-

able years, the excess profits tax for any future taxable year shall be computed by including in the gross income for such year any amount of net abnormal income attributable thereto from a previous year.⁽³⁰⁾ But this increase in excess profits tax liability resulting from such inclusion must not exceed the net decrease in such tax liability for previous years under Sec. 721.⁽³¹⁾ The intent and purpose of this latter provision, of course, is to prevent the claiming of relief under Sec. 721 from resulting, in any event, in an aggregate increase in excess profits tax liability.⁽³²⁾

Wherever applicable, the excess profits tax is computed under the 80% limitation,⁽³³⁾ with proper adjustment in the amount of gross income under the provisions of Sec. 721.

In computing the income tax liability for any taxable year beginning after Dec. 31, 1941, for which the excess profits tax liability is computed under Sec. 721, the amount of the credit under Sec. 26(e) (on account of income subject to excess profits tax) is an amount of which the excess profits tax is 90% or 95% (depending on the excess profits tax rate for such year).

6. Procedure in Claiming Relief under Sec. 721.

The information and facts to be furnished by the taxpayer in support of a Sec. 721 claim are set forth in the Regulations.⁽³⁴⁾ If the taxpayer fails to claim the benefits of Sec. 721 when filing its original return, refund may be claimed on account of such relief by the use of the regular refund claim Form 843,⁽³⁵⁾ or otherwise.

This is one of the advantages of re-

(28) Reg. 112, Sec. 35.721-10.

(29) Sec. 721(c), I.R.C.

(30) Sec. 721(d), I.R.C.

(31) Sec. 721(d)(1), (2), (3), I.R.C.

(32) H.R. Report No. 146, 77th Congress, 1st Session (1941)...CB 1941-1 p. 557.

(33) Reg. 112, Sec. 35.721-4 and -5, shows that the application of Sec. 721 in connection with the 80% limitation may effect a net tax saving, since any amount excluded from gross income under Sec. 721 is subtracted from the corporation surtax net income in computing the excess profits tax (under the said 80% limitation).

(34) Reg. 112, Sec. 35.721-3.

(35) Sec. 732, I.R.C.

lief under Sec. 721—that such relief may be claimed by the taxpayer at any stage of tax proceedings, up to trial before the Tax Court. Such claim can be made, as an offset or otherwise, regardless of the lack of previous consideration of or action on such claim by the Commissioner.

In case of the rejection, in whole or in part, of a claim for relief under Sec. 721, the taxpayer is given the opportunity to appeal to the U. S. Tax Court,⁽³⁵⁾ the final decision on which is to be made by a special division of such Court if Sec. 721(a)(2)(C) is involved.⁽³⁶⁾ Just as under Sec. 722, there is no appeal from any decision of the Tax Court as to any question to the extent that it arises solely under Sec. 721.⁽³⁷⁾

7. Leading decisions of the U. S. Tax Court in Sec. 721 relief cases.

W. B. Knight Machinery Co.,
6 T. C. 519

Relief was allowed the taxpayer with respect to net abnormal income from sales of a new type of milling machine developed by it.

Other gross income of the taxpayer that did not result from its development of the new product was excluded in applying the 125% test and making the computation of net abnormal income.

Direct "costs" and expenses incurred in producing the abnormal income in the taxable year was determined by taking a pro-rata portion of the taxpayer's total selling and other expenses incurred in the production of its total gross income, before further reducing such amount by the statutory formula prescribed in Sec. 721(a)(3)(B).

The Commissioner had stipulated with the taxpayer a method of computation which was rejected by the Tax Court as not being in accordance with the clear provisions of Section 721. The

Court therefore substituted the method it held to be correct.

The Court reduced the net abnormal income attributable to development by applying a factor representing the extent to which the taxpayer's income of the taxable year was attributable to "the improvement in business conditions." This factor was determined by taking the ratio of sales of the industry to which the taxpayer belonged for the taxable year as compared with the average of such sales for the base period.

The apportionment of the remainder of the net abnormal income to the years of the development period was made in the ratio of development expenses for each of such years.

Rochester Button Co., 7 T. C. (No. 65)

Relief was allowed with respect to net abnormal income derived from manufacture and sale of all types of plastic buttons developed by the taxpayer.

All such income was considered as of one class, and treated as a unit, both for the application of the 125% adjustment, and the attribution to the years in which the development expenses were incurred.

The factor of increase in demand due to improved business conditions was established by reference to sales of other similar products manufactured but not developed by the taxpayer.

Other principles established in the Knight Machinery Co. and Southwestern Oil & Gas Co. cases were followed.⁽³⁸⁾

The Court commented several times that the record left much to be desired, but said "...it is easy to understand that a taxpayer's books are not kept with prophetic vision as to the future requirements of income tax legislation."

This case is of particular interest to accountants because of the use by the

⁽³⁶⁾ Sec. 732(d), I.R.C.

⁽³⁷⁾ Sec. 732(c), I.R.C.

⁽³⁸⁾ The Tax Court cited in its decision in this case an early article by the author, entitled "What Price Sec. 721 Relief For Manufacturers," TAXES, October, 1944.

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taxpayer of a standard cost system. The results shown by that system were an essential element in establishing the amount of relief to which the taxpayer was entitled.

Southwestern Oil & Gas Co.,
6 T. C. (141)

Relief allowed the taxpayer with respect to net abnormal income resulting from sales of crude oil from a new stratum developed by it.

The amount attributable to other years was reduced on account of increased unit sales price in the taxable year. No adjustment was made for decreased costs since it was shown that the unit rates of fixed cost increased, and that the large decrease in the overall unit cost of production resulted from the development which was the subject of the claim. No reduction in the amount of relief was made by the Court on account of increased demand for the taxpayer's product, since it was shown that during the test period as well as in the taxable year, there was a ready demand for every barrel of oil that could be produced from the field.

All income from such development was considered as a single class, that is, from "exploration, discovery, and development," as defined in Sec. 721(a) (2)(C), although the facts apparently show that the development of at least some of the wells extended over a period of less than 12 months.

W. B. Davis & Son, Inc., 5 T. C. 1195

The taxpayer was allowed relief with respect to net abnormal income derived from the development of patents based on rights in inventions and patent applications developed in part by it and in part by an employee. Increase in royalties received by the taxpayer were held not due to increase in the physical volume of the sales of product of the type "sold by the taxpayer."

Soabar Co., 7 T. C. (13)

Relief was denied by the Court on

the ground that whatever amount of net abnormal income the taxpayer had in the taxable years was due to improved business conditions which resulted in a greater demand for the taxpayer's products.

The Tax Court pointed out that the development period was completed long before the taxable year and the taxpayer's business had undergone no material change for at least four years.

It does not appear that the taxpayer showed the extent to which the net abnormal income of the taxable year was attributable to such increased demand in that year. The taxpayer apparently depended largely on an attack on the validity and application of Section 30.721-3 of Regulations 109.

Geyer, Cornell, Newer, Inc. 6 T. C. 96

Relief was denied inasmuch as no part of the net abnormal income (advertising sales) of the taxable year was attributable to other years. The increase in income was held to have resulted solely from increased sales (of the taxpayer) due to a greater demand on the part of its customers.

The taxpayer's claim that a portion of the income was attributable to a different year in which the expenditures were made to produce the income was held unwarranted after taking into consideration similar conditions at the beginning and end of the taxable year.

Premier Products Co., et al, 2 T. C.

445; followed in *E. T. Slider, Inc.,* 5 T. C. 263 (in which the result seems to go beyond the principle stated in *Premier Products Co.*); and *James F. Waters, Inc.,* T. C. Memo Decision, Docket 3924 (Pending on appeal, CCA-9).

Taxable gross income from the proceeds of a life insurance policy may not be attributed to any year other than the year of realization, because such income results solely from an investment by the taxpayer in assets producing such income.

Buying and Administering Business Interruption Insurance

By JEROME S. MILLER

Introduction

THE accountant is consulted relative to his clients' Business Interruption insurance more often than in connection with most other forms of commercial insurance. His connection with it, moreover, is not merely transitory. His advice properly should be sought at the inception of the policy term, at least once during this period, and certainly again should a claim occur under the policy.

Property insurance financially safeguards invested capital. Contingent insurance financially safeguards the earnings of invested capital. Business Interruption insurance is a type of contingent insurance applicable to business operations of manufacturers, mercantile firms, service organizations and professional individuals. It is not a new type of insurance, having first been arranged 86 years ago; but, until recent

years, it had remained comparatively unused by a large percentage of business men.

In fact, the National Association of Credit Men made a survey of over 20,000 firms in 45 cities, and found that only 39% of these manufacturers had Business Interruption contracts in their insurance portfolios. An equally interesting sidelight result of the survey was that, of the larger group not carrying this form, only 14% of them had ever been asked to buy it.

The accountant need not, of course, become an expert versed in the variety of applicable forms of Business Interruption insurance. A working knowledge of some aspects of the subject, however, will be exceedingly useful when the accountant comes in contact with this form on behalf of his clients. It is the intention of the author to explain the principles under which Business Interruption insurance operates, its important characteristics as used in New York State, how proper amounts of this form of insurance coverage are arrived at, and how claims are prepared and settled. Details of the subject having academic or insurance interest primarily are left to another time and place. If decided interest is expressed in any specific phase, or by accountants having clients whose activities lie in other States, a more detailed study can be presented in a later issue.

Defining the subject still more clearly, the Business Interruption insurance forms discussed here are only those applying to the perils of fire, lightning, windstorm, hail, explosion, riot, riot attending a strike, civil commotion, aircraft damage, vehicles damage, smoke, vandalism, and malicious mischief. They are considered in the

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"fire insurance" department. There are other forms of Business Interruption insurance applying, for instance, to the "boiler insurance" department, which are not considered at the present time to avoid confusion in explanation.

Function of Business Interruption Insurance

To understand most easily the function of Business Interruption insurance, look, first, at this condensed financial picture of a manufacturer:

MONTHLY OPERATING STATEMENT

Net Sales		\$75,000
Cost of Goods Sold	\$37,500	
Operating Expense (not-continuing)	18,000	
Overhead Expense	15,000	
Total Costs		70,000
NET PROFIT		\$ 4,500

BALANCE SHEET (at end of period)

ASSETS		LIABILITIES	
Cash	\$ 20,000	Accounts Payable	\$ 45,000
Accounts Receivable	40,000	Building Mortgage	50,000
Merchandise Inventory	50,000		
Machinery	35,000	TOTAL	\$ 95,000
Building	100,000	CAPITAL	150,000
TOTAL	\$245,000	TOTAL	\$245,000

Let us assume that at this point the business operations are completely halted by a fire, explosion, windstorm or some such event which destroys the plant. The manufacturer immediately takes steps to replace his building, machinery and materials and through them, his inventory. His expenses, therefore, are:

TABLE NO. 1
EXPENSES FOLLOWING FIRE
(on September 10th)

Building rebuilt (assuming continuance of mortgage)	\$ 50,000
Machinery replaced	35,000
Materials (2 months supply ordered)	75,000
Continued overhead expenses (60% of normal) for 6 months until business is again in operation..	54,000
TOTAL	\$214,000

Yet, assuming every penny of accounts receivable were collected, that amount plus cash, plus \$135,000 of property insurance proceeds (\$185,000 less mortgage principal) would provide

total assets now of \$195,000 far short of the \$214,000 required expenditures shown above plus the \$45,000 of accounts payable.

This prosperous business is thus in difficulty before it can resume full operations, even though its invested capital is completely replaced through property insurance.

Business Interruption insurance, had it been in force, would have provided the amount of money representing (1) the net profits which would have been earned if the business had been operating during that period, and (2) the continuing expenses of the business during the period of non-operation:

TABLE NO. 2
PROCEEDS FROM BUSINESS INTERRUPTION INSURANCE

Net Profits for 6 months	\$27,000
Continued overhead expenses for 6 months, 60% of normal	54,000
TOTAL	\$81,000

This amount, added to the \$195,000 of assets noted directly above provides ample funds for the necessary \$244,000 of outlay and receivables.

Definition of Business Interruption Insurance

Business Interruption insurance covers the loss of money represented by the *earnings* (not merely net profits) lost to a business when a fire or other insured event causes an interruption of its operations. The interruption, depending upon the severity of the fire or other unexpected event, may mean a complete suspension of operations or only a partial suspension of activities. The financial loss so sustained, it is sometimes difficult to realize, can be measured satisfactorily. The insurance contract itself gives the key to the method: "Consideration shall be given to the experience of the business before the loss and the probable experience thereafter."

Its application is to a wide variety of businesses. A dentist, for instance, cannot operate his business at all for 2½ months because his office is damaged by a fire in the building. He does see several emergency patients during that time, however, by arranging with another dentist. His normal \$600 monthly income multiplied by 2½, less the income received from the emergency patients, represents an insurable Business Interruption loss.

A steel mill has its pickling department destroyed by an explosion hampering the production schedule of the mill's finished product for the five months during which that building is rebuilt. The difference between what the mill earned during those five months, and what it would have earned if that department had not been destroyed and production hampered, represents an insurable Business Interruption loss.

A restaurant has its kitchen equipment damaged by fire, and during the fifteen days of repair work cannot accept patrons. The lost earnings repre-

sent an insurable Business Interruption loss.

A Business Interruption policy is a contract of indemnity, which means that it repays a financial loss actually undergone by the policyholder, thus operating to place him in the same financial position he was before the occurrence of the unexpected event. (This is different from a contract of insurance, such as an automobile liability policy, which prevents the policyholder from undergoing any financial loss as a result of an unexpected event by standing in his place in the matter, making any payments or actions in his behalf.)

Description of the Contract

The present day Business Interruption contract is a product of evolution. The original forms provided repayment for net profits lost plus fixed (not all continuing) charges of the business which continued regardless, and limited recovery to 1/300th of the policy amount for each day of total cessation of activities. These unsatisfactory limitations brought forth a contract to cover net profits plus all charges and expenses of the business which did continue, but it was still subject to a recovery limit per day. A weekly form was later introduced, and finally the more satisfactory and still current contract known as the Co-Insurance Two-Item form.

The contract presumes sufficient insurance is being carried, penalizing a claim collection proportionately to the extent that it is not. It provides payment of the earnings actually lost during the period of interruption. Thus a one month interruption of a highly seasonal business may cause a 30% loss in the annual earnings, or a three month interruption a 75% earnings loss, both recoverable through the business interruption contract.

The approach to loss of earnings stated in this so-called Two Item form is the payment of (1) net profits plus (2) charges and expenses of the business which continue during the period of interruption. The contract, in its

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description of these charges and expenses, specifically excludes from the category any portion of the "ordinary" payroll expense but does include supervisory, contract, managerial, executive or officer payroll. If repayment of "ordinary" payroll expenses during the interrupted period is desired it can be included as Item Two in the form (whence comes the contract's name).

The combination of net income and income which pays expenses of the business as the "object insured" is important. In most instances it is found during a given period the expenses of the business which must continue exceed the net income.

Many articles and services are contracted for over a period in expectation of then-to-be current earnings. Other expenses continue during any period of interruption, if customers are to be retained and the operating staff of the business held together. Thus, even a business operating at a loss has a need for Business Interruption insurance. In case of fire or other event the continued expenses would be recovered in the same proportion that they were being met by the business while in operation. This was an important factor to many firms, for instance, during the years 1930-34.

The approach to the payment of lost earnings is somewhat different in the newer so-called Co-Insurance Gross Earnings form of contract. This was made available to non-manufacturing firms in 1939 and to manufacturers in 1945. The measure of recovery here is not (1) net profits plus (2) continuing expenses but, instead, includes (1) gross earnings less (2) expenses not continuing. By this approach to the same result the amount of annual "ordinary" payroll which the business finds necessary to continue during the restoration period is automatically insured. A difference in the co-insurance

requirements allows the buyer a wider choice in his selection of either of these forms, however; a point which will be illustrated under a separate section below.

The term "gross earnings" in the policy is defined, to avoid any disagreement with accounting practices of specific policyholders. In policies arranged for non-manufacturing and mercantile firms it is defined as the total net sales less the cost of merchandise sold, plus other earnings derived from the operation of the business. ("Other earnings" might be, for instance, income from leased departments in a department store.) When applied to manufacturers the contract defines gross earnings as the total sales value of production through use of the premises insured, less only the cost of raw stock from which the production is derived. This latter varies from many manufacturers' accounting statements, which hold the gross profit to be the net sales value, less both the cost of materials and supplies and the cost of manufacturing labor and overhead. It now becomes apparent why the accountant's advice should be part of the selection of Business Interruption insurance by the client.

The terms used in the work sheets to compute business interruption insurance values are in many instances at variance with accountants' use and understanding of the terms. Thus, reference to the explanatory notes attached to Exhibit A will reveal more clearly the need for proper guidance for the client.

Although lost earnings are themselves insured under the Business Interruption contract, it is well to remember that the insurance comes into active play only when the operations of the business are disturbed by fire or other insured event damaging the premises (or its equipment) described in the policy.¹ A fire which guts an important

¹ The one exception to this is the instance, specifically mentioned in the contract as "Interruption By Civil Authority", of access to the insured premises being prohibited by civil order because of a fire or other event occurring in the vicinity. Claim for loss of time in this circumstance is limited to two weeks.

EXHIBIT A

COMPUTING BUSINESS INTERRUPTION INSURANCE VALUE

FROM

1. Net Income or Sales Value of Production.....	\$.....
2. Other Operating Income, and	
3. Inventory at close of fiscal year.....	
Total	\$.....

DEDUCT

4. Inventory at start of fiscal year, and	\$.....
5. Net cost of goods purchased.....	
Total	\$.....

TO OBTAIN Gross Margin or Profit, which represents

GROSS BUSINESS INTERRUPTION INSURANCE VALUE..... \$.....*

DEDUCT

6. Annual Ordinary Payroll plus Payroll Taxes and Compensation Premium	\$.....
7. Annual cost of Heat, Light and Power, except charges under contract....	
Total	\$.....

TO OBTAIN

8. Basis for Insurance—Item I.....	\$.....
9. Revision for expected business trend.....	

ESTIMATE OF INSURANCE—ITEM I.....**

10. Basis for insurance—Item II.....	\$.....
11. Revision for expected payroll variation.....	

ESTIMATE OF INSURANCE—ITEM II.....**

*This figure, revised for expected business trend, is the estimate of the 100% insurable value under the Gross Earnings form.

**These figures represent the 100% insurable value under the Two Item form.

In each instance adjustment in this amount must be made before insurance is ordered, depending upon the co-insurance percentage selected. In the Two Item form it is always 80%. In the Gross Earnings form it may be 50%, 60%, 70% or 80%.

Buying and Administering Business Interruption Insurance

EXHIBIT A (continued)

EXPLANATORY NOTES

1. In mercantile or service enterprises, net income is obtained by deducting discounts, shipping costs, bad debts and returns from annual sales. In manufacturing operations the basic figure is developed by making similar deductions from the annual sales value of production.
2. Other operating income, such as commissions and rents from leased departments that would cease as a result of fire or other insurable peril.
- 3-4. When developing values for concerns of a service nature, inventory values should be considered only when such inventories are of material size and have a bearing on operating profit or loss. In manufacturing risks, *only inventory values represented in raw materials* should be included.
5. Cost of goods purchased: Include inward freight, express and cartage. Deduct all discounts and allowances received.
6. By ordinary payroll is meant total annual payroll, less salaries of officers, executives, department managers, supervisors, employees under contract and other important employees whose salaries would necessarily continue regardless of length of time business operations might be interrupted. This figure does not include that portion of ordinary labor costs directly chargeable to heat, light and power expense—see note 7. The amount developed under this item should be increased by the sum of social security taxes paid by employer and compensation insurance costs in connection therewith.
7. Annual cost of heat, light and power, including labor cost in direct connection therewith is insured without charge, but deducted before premium calculation is made. Where, under contract, there is a minimum charge for these services, the amount for insurance purposes, is the excess above such minimum.
8. The total of items 6 and 7 subtracted from the Gross Insurance Value produces the amount of insurance that would have been required during the fiscal year under review to provide 100% protection under Item I of the Two Item form.
Under the Two Item form the amount of insurance to be carried is divided: Item I insures net profits and such charges and expenses as must necessarily continue, including salaries (but excepting ordinary payroll as defined in note 6.) Item II insures ordinary payroll for a period of not less than ninety consecutive days. Coverage under Item II is optional.
9. If increase or decrease in volume of business is expected for the ensuing twelve months, total developed above should be adjusted upward or downward accordingly.
10. The cost of ordinary payroll for the highest ninety consecutive day period produces the amount of insurance during the fiscal year under review that would have been required to provide 100% protection under Item II. Protection of ordinary payroll for a longer term than ninety days may be procured if desired.
11. If material increase or decrease in ordinary payroll expense is expected for ensuing twelve months, total developed above should be adjusted upward or downward accordingly.

source of supply for a plant or store, thus causing a loss of earnings to that plant or store by interruption of deliveries does not constitute a claim under the receiver's policy. (That circumstance may be insured however by means of either contingent insurance brought by the plant or store, or a blanket policy covering both the original firm's premises and its important sources of supply, processors or contractors.)

New York State has six differently titled Business Interruption insurance forms. There are two Co-insurance Two-Item forms, one for non-manufacturers and the other for manufacturers; two Co-insurance Gross Earnings Forms, for non-manufacturing and for manufacturing buyers; and two Weekly forms, for non-manufacturers and for manufacturers. The Weekly form, based on the net profit plus continuing expenses approach to the measure of lost earnings, has a further limit of recovery of 1/50th of the policy amount for each week of total suspension, or a proportionate part of this 1/50th for each week of partial suspension. It is the least often used form.

Co-insurance a Requirement

The co-insurance principle is an integral part of the Business Interruption insurance contract. Thus, to avoid a penalty in claim settlement amount an adequate amount of insurance must be in force *at the time of the loss*. It is presumed the reader is familiar with the co-insurance principle that the holder of inadequate insurance suffers a penalty, in that his recovery will be limited to the percentage of the insurance which he did buy to that which he should have bought, applied to the total amount of the loss occurring (but not in excess of the face amount of the policy).

In New York State work sheets are made available by the insurance organizations to help the buyer determine the proper amount of insurance required. (See Exhibits B and C.) They are not

required to be filed with the insurance company nor do they become part of the insurance contract. They might well be kept by the insurance adviser, the client, or both. It is strongly recommended that they be used not only as an important guide to terms and procedure in computing the proper insurable value, but because they bring clearly to the attention of both the client and the accountant the fact that from the figures developed *there should be added or deducted the anticipated increase or decrease in earnings for the year ahead*.

Property insurance contracts against fire contain a co-insurance clause which is applied against the value on the *date of fire*, not the date of policy inception. Similarly, business interruption contracts, which repay earnings lost starting from the date of fire until the business can operate completely again, measure the value of the earnings of the business starting from the *date of the fire*, and not from the date of policy inception.

The twelve months starting from the date of the fire (or other insured event) is used as a measure not only of recovery of earnings lost but also of the total insurable value of the business for the purpose of applying the co-insurance requirement. The policyholder, therefore, must estimate today what his business situation might be for the twelve months immediately following that unknown day when a fire might occur.

Notice the earnings called for on the worksheets are on an annual basis. The co-insurance clause in the Two Item form refers to the insurable value as the "sum of the annual net profits and the annual amount of all charges and other expenses of any nature *whether continuing or not* (except the expense of heat, light and power to the extent that such expense does not continue under contract and the insured's entire ordinary payroll expense) that would have been earned, had no loss occurred, during the twelve months immediately following the date of loss." Similarly, in

the Gross Earnings form the clause refers to the *entire* gross earnings "that would have been earned, had no loss occurred, during the twelve months immediately following loss."

This may seem inconsistent with the fact that the measure of recovery is limited to profits and *continuing* expenses only, or gross earnings less *discontinued* expenses.

The amount of insurance bought, apparently can never be collected in full. It must be remembered, however, that the percentage of charges and expenses which continue depends upon the length of the period of inactivity. A complete cessation for one day may result in no discontinuance at all of charges and expenses. A cessation extending over six months may require, during that time, continuance of only 50% of normal charges and expenses. Since the insurable value for an entire year must be computed it must be done on a basis to provide a measure proper for a one-day suspension or twelve month suspension. The seeming injustice done the policyholder in requiring this measure of insurance to be carried is made up by the insurance company using a rate per \$1000 of insurance lower than the rate applied to property fire insurance.

Too much criticism, in the opinion of the author, has been leveled against the difficulty involved in keeping in force a proper amount of business interruption insurance because of this measuring rod. Certainly a periodic check on the trend of the business can be made by the policyholder to confirm the adequacy of this important insurance. Whether the accountant, as a matter of service, wishes to bring the need for this check-up to the client's attention periodically is beside the point. The fact remains that such an interim check-up is no more than is required for safety in connection with property insurance contracts covering merchandise, buildings, equipment, etc.

The objection to the obligation placed upon the policyholder to keep

property insurance constantly adequate in amount has been met in part by the use of the reporting forms for the insurance of stocks of merchandise.

There have also already been found some solutions to the obligation of estimating in advance what the business interruption insurable value of a business will be for the twelve months subsequent to the date of loss. An "agreed amount" clause may be added to the policy for some types of policyholders under which, based on a signed statement of actual values for the previous year and estimated values for the current year, the company agrees that the amount of insurance thus shown is considered adequate regardless of the actual experience of the business subsequently, and the co-insurance clause is removed. Firms not hesitating to file statements with the underwriters' rating organization, and agreeable to the underwriters having access to their books and records for the purpose of verifying the statements filed, find this clause valuable.

More recently, in Pennsylvania, Maryland and Delaware there has been introduced a reporting form of contract. This provides (as in the merchandise reporting forms) for an initially named limit of insurance to be corrected at the policy termination by the filing of a statement of actual values achieved during the past year, with subsequent adjustment of premium. The possibilities of under-insurance and over-insurance are thus avoided. Although changes will be necessary in this form before it will become readily acceptable to buyers, it is the opinion of the author and others familiar with the subject that ultimately a convenient reporting form will be introduced in all insurance jurisdictions and will become the most widely used form of business interruption insurance because of its justice as to both protection and premium treatment to insurance carrier and buyer alike.

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EXHIBIT B

**BUSINESS INTERRUPTION INSURANCE WORK SHEET
TWO ITEM FORM**

Item I

All Entries for Item I are on an Annual Basis

- A. Net sale value of production or total net sales (Gross sales, less discounts, returns, bad accounts and prepaid freight, if included in sales)..... \$.....
- Deduct:**
1. Cost of raw materials or merchandise (all materials and material supplies entering into articles produced, if a manufacturing concern, or cost of merchandise sold if a mercantile establishment)..... \$.....
2. Ordinary Payroll (including insurance premiums and all taxes on said payroll)..... \$.....
3. Cost of heat, light and power in excess of minimum contract expense \$.....
- B. Total Deductions \$..... \$.....
- A Minus B \$.....
- Add or deduct anticipated increase or decrease for the coming year \$.....
- C. \$.....
- 80% of C is the minimum amount of insurance that should be carried under Item I of the Form..... \$.....

Item II

Item II is the ordinary payroll expense for 90 consecutive days. (Select the largest probable 90 day payroll expense for the coming year.) 80% of this is the amount that should be carried under Item II of the Form \$.....

NOTE: Ordinary payroll should not include any salaries insured under Item I.

Explanatory Notes:

- To obtain cost or value of raw materials in manufacturing risks, or cost of merchandise sold in mercantile risks, we suggest the following procedure:
- Inventory at beginning of fiscal year..... \$.....
- Net cost of raw materials or merchandise purchased during fiscal year (purchase price less discounts) \$.....
- Cartage and Transportation charges on incoming materials or merchandise.... \$.....
- Total \$.....
- Deduct:—Inventory at end of fiscal year..... \$.....
- Amount for Item A-1..... \$.....
- Note: Inventory increases or decreases based on price fluctuations, rather than quantity increases or decreases, should be adjusted if possible so as to conform with probable costs for the ensuing year.

Dated.....

Buying and Administering Business Interruption Insurance

EXHIBIT C

BUSINESS INTERRUPTION WORK SHEET

GROSS EARNINGS FORM

MERCANTILE RISK

ALL ITEMS TO BE ON AN ANNUAL BASIS	Column 1 Actual Values for Year Ended.....	Column 2 Estimated Values for Year Ending..... Estimate.....% Increase or Decrease
A. Total Annual Net Sales (Gross sales less returns and allowances).....	\$.....	\$.....
B. Deduct Cost of Merchandise Sold.....
C. Operating Gross Profits (excluding other income)
D. Add Other Earnings Derived From Operation of Business (other than Sales):		
1. Cash Discounts Received.....	\$.....	
2. Commissions and Rents from Leased Depts.	
3.	
4. Total Additional Income.....
E. Gross Earnings
F. Take 50%, 60%, 70% or 80% of Item E. Column 2 as amount of insurance required, depending upon percentage contribution clause to be used in policy (...%).....	

Dated.....

NOTE: When the above work sheet is submitted as an application for the Agreed Amount Clause, Form G, on fire resistive or sprinklered mercantile risks, the following statement must be signed by the insured.

I hereby certify that the above statement of Actual Amounts for the year ended 19... has been prepared, or verified, by me and is true and correct to the best of my knowledge and belief, and that the estimated amounts for the year beginning with the date of this Statement are in my judgment justified by the statement of Actual Amounts and a reasonable forecast for the future.

The undersigned hereby agrees that the Rating Organization having jurisdiction shall be permitted at all reasonable times to examine the applicant's books and records for the purpose of verifying the values herein stated.

Date of this Statement.....19....

Signature of member of firm or officer of corporation.....

1946

561

Limitations of the Contract

1. The period of liability covered by the contract is usually limited to one year from the date of fire or other event. This period may be increased by making the proper notations in the contract: no rate difference occurs, the obligation of the policy buyer being however to purchase enough insurance to meet the earnings of the business over the 14 month or other period desired.

Incidentally it may be well to make clear that the period of liability has no connection with the term of the insurance policy. A firm may buy a Business Interruption policy on January 1st and experience a fire on December 31st. The period of liability of the company starts on the day of the fire and continues thereafter for the 12 or other month limit named; so that if the business were shut down for a year or more it would receive possibly the full amount of insurance named.

2. In order to help himself get back to normal operations quickly a policyholder may take extraordinary means, such as hiring laborers, repairmen or machinists to work on a 24-hour basis or on Sundays; hiring temporary quarters or work places; having equipment transported by air express; and others. He may feel the extraordinary expense warranted because of the time saved in getting back to normal operations. The insurance company agrees to pay these extraordinary expenses to the extent only that they reduce the whole insurance loss. Thus if, by taking some such measure as is described above, a merchant is able to open his doors one week sooner than if he had not, the company would pay the \$400 expenses so incurred; the advantage thereof to the insurance company is, of course, the saving of the payment of, say, \$550 for an additional week's lost time claim. If these expenses however had totaled \$650, they would have paid only the limit (the amount by which the whole

insurance loss is reduced) of \$550, the amount which would have been paid had no extraordinary measures been taken and business operations were suspended until the repairs were completed in the ordinary course of things.

This so called "expediting expense" clause should not be confused with a different form of contingent insurance titled Extra Expense insurance. That type is not based on business earnings lost during a period of interruption. It is simply arranged to provide money to meet extra expenses involved in keeping a business in normal operation after a fire or other event. * Used by a few special industries of a service nature, it pays the extra cost of publishing the daily newspaper, delivering the milk, processing and delivering the laundry, etc. The amount of extra expense insurance bought is based on what the buyer estimates such expenses might be for a number of months, taking into account that, while there is obviously no co-insurance involved, there is a month-by-month limit of liability.

Conceivably a firm could buy both forms of insurance, Business Interruption and Extra Expense. But situations which would interrupt sales or production operations so that earnings are reduced, and also enable (through the use of abnormal expenditures) the normal operations of the business to continue seem rare indeed. A firm which "must deliver" come what may, has more need for Extra Expense insurance than Business Interruption insurance.

3. Remembering that the purpose of Business Interruption insurance is to repay earnings lost because of inability to use equipment or occupy business premises, it will be realized promptly that it cannot be the intention of this type of insurance to pay for the additional time it may take to replace stock which has been damaged or destroyed. The contract does contain, however, provision for some such coverage.

A. *Stock for sale* by a mercantile es-

tablishment or *stock-in-process*² by a manufacturer naturally has to be replaced, and it is considered that this can be accomplished during the period of repairs to the premises or equipment. If this replacement takes longer, thus keeping the business suspended longer than the period of repairs, the additional time is made part of the insurance loss; but this additional coverage is for 30 days, only, in the usual contract, with a longer period possible at an additional premium.

B. If *raw stock* of a manufacturer be destroyed, coverage is granted subject to the 30 day (or more, if bought) limitation for the necessary additional time this stock would have enabled the plant to operate or for the time required to replace the raw stock itself, whichever period might be shorter.

C. Any interruption to a manufacturing firm resulting from damage or destruction of *finished stock* is not covered.

Selecting the Form

The choice between the Two Item form and the Gross Earnings form is made usually on the basis of these points:

1. *The importance of ordinary payroll being covered.* A review of loss adjustments shows that in a short shutdown practically all ordinary payroll expense continues, while in long periods usually only a comparatively small amount of the total payroll expense continues. It must be decided first whether it is worthwhile for economic, morale, premium or other reasons to include ordinary payroll at all. If so,

the necessary or most desirable period of coverage is selected. The Gross Earnings form, remember, includes ordinary payroll automatically. It is written on a minimum 50% co-insurance basis, which would mean that six months of earnings and payroll would be insured; on a 60% co-insurance basis thus covering 7.2 months; 70% basis covering 8.4 months; and 80% basis covering 9.6 months as a minimum amount of insurance.³ The Two Item form covers a minimum 3 months period of payroll, if desired at all, subject to 80% co-insurance, or thus 2.4 months. Longer periods than 3 months can be selected and are still subject to 80% co-insurance.

Thus, if no ordinary payroll need be included, or if only a few months such coverage is desired, on this point the selection of the Two Item form is indicated.

2. *The length of time considered necessary for rebuilding* in case of total destruction of premises. This is a factor because the Two Item form is based on 80% co-insurance, meaning that the minimum amount of insurance adequately bought would provide insurance over a 9.6 month shutdown, whereas the Gross Earnings form, written on the minimum 50% co-insurance basis, provides thus 6 months insurance. If the possibility of total destruction is present, or if the time-to-rebuild would be a long one it may be important to use either the Two Item form, even if payroll is included as item two, rather than a 50% Gross Earnings form, or a Gross Earnings form with a higher co-insurance basis at a higher premium.

² Raw stock is defined in the policy form for manufacturers as materials and supplies in the state in which they were received.

Stock-in-process is defined as raw stock which has undergone any seasoning or aging, mechanical or other process of manufacture at the premises insured but which has not yet become stock which is finished and ready for sale.

³ In these examples of figures, only the minimum coverage to satisfy the co-insurance requirement is illustrated.

A firm may obviously buy insurance, on an 80% co-insurance basis, in an amount (say, \$12,000) equal to a full year's insurable value. Having satisfied the co-insurance requirement they could collect for 12 months of interruption if necessary. If they were to buy the minimum amount of insurance to satisfy the co-insurance requirement ($\$12,000 \times 80\%$) or \$9,600, it is clear they would suffer no penalty in case of claim, but would have insurance enough only to last for a 9.6 month interruption.

3. *The premium difference.* Cost comparison can be made by use of the type of worksheet illustrated in Exhibit A, which can show the amounts of insurance necessary for both forms. A brief illustration can be given here to make procedure, but not rates or results, clear. New York City rate arrangements are such that the Gross Earnings form with 50% co-insurance takes a rate equal to the premises contents rate less 40%; and the Two Item form takes for item one a rate equal to the premises contents rate less 45%. A firm showing net sales of \$100,000; cost of goods sold of \$40,000; important payroll of \$10,000; and ordinary payroll of \$30,000 briefly would have a Gross Earnings insurable value of (\$100,000 minus \$40,000) \$60,000 and a Two Item insurable value, disregarding any payroll coverage at all, of (\$100,000 minus \$40,000 minus \$30,000) \$30,000. If the premises contents rate were \$1.00 per \$100 of insurance, \$60,000 of Gross Earnings form on an annual basis would require a \$30,000 policy on a 50% co-insurance basis to be bought at a rate of \$.60 and a premium of \$180. \$30,000 of net earnings would require a policy of \$24,000, since that form is always on an 80% co-insurance basis, and it would be bought at a rate of \$.55 and a premium thus of \$132. If the minimum payroll coverage were now added (which would be \$6,000, or three months of the annual ordinary payroll times 80%) at the proper rate of (item one rate plus 50%) \$.825, that premium would be \$49.50. The total Two Item premium including payroll coverage would then be \$181.50 against the Gross Earnings form premium of \$180.00. The conclusion here, and here only, would therefore be that if no ordinary payroll is desired the Two Item form is only \$132.00 as against \$180.00; but if any payroll coverage is desired the Gross Earnings form at \$1.50 less premium would give 6 months payroll coverage rather than 2.4 months such coverage. It is hoped the reader will not miss the point however that, as to earnings, a period of 6

months is insured under the Gross Earnings form in this example, whereas 9.6 months protection is supplied by item one of the Two Item form.

This example must not be taken as a rule since the results will vary with the type of business and its accompanying importance of the payroll figure in earnings, and with the rate itself, which may heighten or less the dollar difference in premium between the two forms.

Mercantile firms have been attracted in the main more to the Gross Earnings form probably because it is a little more easily explained and understood, it necessitates no separation of payroll figures in the determination of insurance amount, and its coverage is applicable to most stores. According to the administrative officer of one company active in this special field 75% of all mercantile Business Interruption policyholders use the Gross Earnings form.

Manufacturing firms are approaching the Gross Earnings form a little more slowly because it is a form new to them. The requirement that only the cost of raw material be deducted in figuring the insurance gross earnings value means, in some industries, a comparatively large amount of insurance is required as compared with the Two Item form. Heavy industries are probably likely to look with disfavor upon any form giving only six months coverage, and will use a 70 or 80% co-insurance basis if they select the Gross Earnings form. Manufacturing plants involving heavy "ordinary" payrolls will probably hesitate to insure those payrolls for a long period.

Claim Settlement

A business interruption claim is no different in essentials than other insurance claims. When sufficient insurance is carried, the claim settlement usually proceeds happily, and when insufficient insurance is found to have been carried the attitude of the insurance company toward all details of the claim is often considered by the claimant to be exacting and carping. An article, for in-

stance, in the July, 1945, issue of the National Retail Dry Goods Association Bulletin written by the claimant's attorney, complains of the trouble involved in settling a Business Interruption insurance claim (which finally went to litigation). In the report the attorney maintains the disagreement began because neither the store nor its attorneys could understand why they must insure all profits and expenses when they could collect only for profits and *non-continuing* expenses! Will policyholders always wait until after-the-loss to read or discuss their policies?

Claim settlement procedure revolves around these four points:

1. The insurable value of the business.
2. The period of suspension of operations.
3. The extent of this suspension: that is, is it total; total in one department only; partial over the entire plant; etc.
4. The effect of this suspension upon the earnings and expenses of the business.

After he has made an inspection of the physical damages to the premises, the loss adjuster will usually ask for the most recent operating statement of the firm. The insurable value is now determined by consulting (1) the operating statement for the last 12 months, to determine earnings charges and expenses, (2) the statements for the previous two or three years, and the figures relating to the few months immediately prior to the date of fire or other insured event. This is to determine the trend of the business in order to make any upward or downward correction of the annual figure developed in step (1). A prominent adjuster stated to the author that he has never had any disagreement at this step in claim settlement.

The second step, determining the period of suspension, is equally without

complication. The mechanics, builders, and other technical men representing the claimant and the insurance company consult together and decide how long it will take to repair or replace or rebuild whatever is necessary. And here, in most claims, is the completion, generally, of the second step. If the builders (on both sides) agree that it will take 9 weeks to repair what has been damaged; or if the machinery supplier reports that it will take 17 weeks to set up and deliver the machinery required replaced by the policyholder, this is as exact a measure as is necessary. Thus, as a practical matter there is no need to wait until the premises are actually rebuilt or repaired completely. The claim settlement can be continued and completed on the basis of the business being interrupted for the 9 weeks or 17 weeks thus determined. This procedure enables the policyholder to obtain his insurance proceeds promptly, when he may have an important use for the cash.

This point may seem to be at variance with previous thoughts or descriptions of loss settlement. A moment's consideration however will enable the reader to realize that the procedure in this respect is not different from other types of claims. An apartment building, for instance, is damaged by fire. The property fire insurance claim is settled without the parties waiting until the building is actually rebuilt to determine exact replacement value. The rent insurance claim is settled also without waiting for actual rebuilding.

In steps 1 and 2, it should be noted that even though the policy contract makes the preparation of the claim the obligation of the policyholder, in practice the insurance company adjuster takes the initiative in the determination of the insurable value and period of suspension.

The additional time which may be required to replace stock, as permitted by contracts, usually can be predetermined also. If this is a factor in an interruption the time agreed upon is

added to the previously determined period of suspension.

The third step, the determining of the extent of the suspension becomes a factor only when a partial suspension occurs. It is then a matter usually decided by agreement between the policyholder and the company. In claims of manufacturers emphasis is placed on production. In mercantiles emphasis is on sales. A partial suspension is most often determined as a percentage of full operation and, having been thus determined, is no more complicated in claim completion than a total suspension.

The final step, determination of the loss in earnings, is accomplished most often by using the figures of the comparable period of the previous year as a basis. It is felt an understanding of loss computation procedure can be more easily gained by close reference to two actual loss examples shown in Exhibit D and Exhibit E, than by explanation in the text.

Exhibit D shows a fairly simple computation based on actual sales production lost. Actual figures of production were used because the loss was a partial suspension in the last three weeks of the month. The percentage of production lost to total annual production is applied to the computed annual insurable value. The policy involved here was the Two Item form with no coverage on ordinary payroll.

Exhibit E shows the computation of a loss under the Gross Earnings policy. Here the percentage of gross earnings to sales is a sound basis in determining gross earnings lost during the period of interruption. The percentage of expenses saved during the period is also a factor which is calculated (this is not shown in detail in the Exhibit).

If either of these firms showed erratic earnings or were highly seasonal businesses, further correction would be made for this factor before the final loss figure was accepted.

Buying and Administering Business Interruption Insurance

EXHIBIT D

CLAIM SETTLEMENT—MANUFACTURING COMPANY

(Part One)

Sales—January	\$ 86,000	
February	80,000	
March	69,000	
April	61,000	
May	56,000	
June	45,000	
July	50,000	
August	61,000	
September	76,000	
October	83,000	
November	81,000	
December	84,000	
Net Sales		\$832,000
Cost of Sales:		
Inventory, January 1.....	\$ 71,000	
Purchases	594,000	
Heat, light, etc.....	7,500	
Ordinary labor	75,500	
Supervisory labor	4,700	
	<u>\$752,700</u>	
Inventory, December 31.....	69,000	683,700
Gross Profit		\$148,300
Expenses:		
Ground rent	\$ 2,000	
Depreciation	6,500	
Repairs	4,800	
Postage	900	
Printing & stationery.....	400	
Credit & collections.....	500	
Dues	300	
Insurance	5,200	
Advertising	3,600	
Interest	4,500	
Taxes (other than on income).....	1,800	
Traveling expense	6,000	
General expense	4,000	
Salaries—officers	23,500	
Salaries—office	10,000	
Salaries—sales	15,500	
		<u>89,500</u>
Net Profit		\$ 58,800

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EXHIBIT D

(Part Two)

Determination of Insurable Value:

Net Profits	\$ 58,800	
Expenses	89,500	
Supervisory labor added in.....	4,700	
	<u>\$153,000</u>	Annual Insurable Value
		No correction necessary for increased or
		decreased trend of business.
	.80	Co-insurance requirement
	<u>\$122,400</u>	Insurance Required
	<u>\$125,000</u>	Insurance actually carried. Co-insurance
		requirement satisfied. No loss penalty.

Determination of Insurance Claim—Two Item Form, no payroll coverage

Net profits	\$ 58,800	
Expenses which continue.....	81,900	
		Reduction in expenses here considered as
		to repairs, postage, printing, insurance,
		general and traveling expenses
Supervisory labor	4,700	
	<u>\$145,400</u>	Annual collectible loss
November production anticipated, based on last year's figures....	\$ 81,000	
Actual November production...	49,000	
Loss in production.....	\$ 32,000	of annual \$832,000
32/832 x \$145,000 =	\$5,577	Amount of insurance collectible

Buying and Administering Business Interruption Insurance

EXHIBIT E

DEPARTMENT STORE CLAIM SETTLEMENT

(Date of fire: December 28. Operations interrupted through March 31.)

A: Sales Calculation:

Sales—January	\$102,254.24	
Sales—February	103,218.20	
Sales—March	<u>118,005.26</u>	
Sales—3 months ending March 31st.....		\$323,477.70
Fiscal period ends May 30th:		
Previous year—7 months ending December 31st....	\$392,395.41	
This year—6 months and 27 days to fire		
December 28th	\$370,243.95	
Add for December 28th, 29th, 30th, 31st,		
actual sales last year.....	<u>11,102.81</u>	
Comparable total for 7 months this year.....	381,346.76	
Decrease in current year sales.....	\$ 11,048.65	
Decrease is .02816 of last year's sales, and .02816 of		
\$323,477.70 is		<u>9,109.13</u>
Sales expectancy for 3 months ending March 31st....		<u>\$314,368.57</u>

B: Gross Earnings Percentage Calculation:

Actual sales 6 months and 27 days: June 1st to		
December 28th	\$370,243.95	
Gross earnings for same period.....	<u>168,423.80</u>	
Percentage of gross earnings to sales \$168,423.80		
divided by \$370,243.95 =	<u>.4549</u>	of sales

C: Calculation of Income from Date of Fire to March 31st:

Physical Loss Statement (excluding merchandise taken over by Underwriters Salvage Co.: sold furs, supplies, "will calls" and employees' clothing):

	Total Value	Agreed Loss	Salvage
Dept. A—Fur	\$159,657.34	\$ 95,545.88	\$ 64,111.46
B—Coat \$24,706.18}			
C—Dress 15,244.11}	39,950.29	12,294.37	27,655.92
Totals at cost value.....	<u>\$199,607.63</u>	<u>\$107,840.25</u>	<u>\$ 91,767.38</u>
Estimated mark-up 50% of cost or 33 $\frac{1}{3}$ % of sales			45,883.69
Estimated selling value of salvage.....			<u>\$137,651.07</u>
Add estimated special order sales.....			<u>11,250.00</u>
Estimated Sales Income from date of fire to March 31st..			<u>\$148,901.07</u>

D: Calculation of Loss:

Expected Sales (A above).....	\$314,368.57	
Less estimated sales income after fire (C above)....	<u>148,901.07</u>	
Estimated sales lost.....		\$165,467.50
Estimated cost of sales—100% less .4549 (B above)=		
.5451	\$ 90,196.33	
Estimated saved expenses for same period=.0349....	<u>5,774.80</u>	95,971.13 •
Estimated gross earnings lost 3 months ending March 31st		\$ 69,496.37
To adjust and round out.....		<u>503.63</u>
AGREED LOSS		<u>\$ 70,000.00</u>

A New Allocation Ruling Affecting Some Business Corporations Subject to the New York State Franchise Tax

By J. B. C. Woods, C.P.A.

THE formulae under which business and investment income and capital are allocated for the New York State franchise tax under Article 9A, like other arithmetical formulae for allocation, may produce incongruous or inequitable results in some instances. In a paper on the allocation of income read at the New York University 1945 Conference on the Franchise Tax on Business Corporations, Leo Mattersdorf noted the shortcomings of such formulae, quoting from the National Tax Association proceedings, 1939, to emphasize the point:

"It must be admitted that the use of mathematical formulae is arbitrary and that no one rule will be equitable for all concerned. Nevertheless, in the absence of a more accurate method it is a practical way of dealing with the problem that has the approval of both tax administrators and taxpayers."

And, again, "no mathematical formula can hope to achieve exact, even-handed justice, but can work only substantial justice. In exceptional cases the result will be grossly inequitable."

When the present Article 9A was

enacted, the possibility of inequities of allocation under the prescribed formulae was recognized, and Section 210 sub-division 8 was inserted in order to give equitable relief, taking the place of sub-division 7a of Section 214 of the prior Article 9A. The present Section 210 (8) reads as follows:

"If it shall appear to the tax commission that any business or investment allocation percentage determined as hereinabove provided does not properly reflect the activity, business, income or capital of a taxpayer within the state, the tax commission shall be authorized in its discretion, in the case of a business allocation percentage, to adjust it by (a) excluding one or more of the factors therein, (b) including one or more other factors, such as expenses, purchases, contract values (minus subcontract values), (c) excluding one or more assets in computing such allocation percentage, provided the income therefrom is also excluded in determining entire net income, or (d) any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attributable to the state, and in the case of an investment allocation percentage, to adjust it by excluding one or more assets in computing such percentage provided the income therefrom is also excluded in determining entire net income. The tax commission from time to time shall publish its rulings with respect to any application of the provisions of this subdivision."

In conformity with the foregoing, a Tax Commission Ruling was issued July 30, 1946, reading as follows:

"Where corporation owns no real property within and without state and tangible personal property owned consists of solely furniture, fixtures, and other office equipment—Discretionary adjustment of allocation percentage.

—1. In the case of any corporation (a) taxable under Article 9-A of the Tax Law, (b) entitled to an allocation of its business income and capital, and (c) which (within and without New York) owns no real property and whose ownership of tangible personal property (within and without New York) is

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comprised solely of furniture, fixtures and other office equipment, the Tax Commission will, upon application of the taxpayer, eliminate the property factor in the calculation of the taxpayer's business allocation percentage. In such a case, the Commission may substitute, as a third factor, the percentage which the taxpayer's business expenses (other than salaries and wages) incurred or expended within New York to bear to the total of such expenses within and without New York.

"2. Any corporation, making application for such discretionary adjustment, must annually file its report and calculate its business allocation percentage using the statutory formula; it must attach a rider to the report (a) setting forth the items and value of all tangible personal property owned by it and (b) the items of its business expenses (other than salaries and wages) incurred or expended within New York, together with the items of such expenses incurred or expended within and without New York. In the case of reports heretofore filed, subject to any statutory time limitation, taxpayers may apply for such discretionary adjustment by supplying the required information in an affidavit executed by an officer of the corporation.

"3. In the case of any corporation circumstanced as above, the Commission may, of its own motion, make a discretionary adjustment by the elimination of the property factor and, in such case or in the case of any corporation which (within and without New York) owns no real or tangible personal property, may substitute as a third factor the percentage of expenses as set forth above. The Commission may require of any corporation such information under oath as it deems necessary to make such adjustment.

"4. 'Business expenses' include only expenses used in the calculation of the taxpayer's entire net income incurred or expended in service, maintenance and operation of a nature as may be allocated within and without the state such as (1) rent, (2) office supplies, (3) traveling or entertainment, (4) postage or communication, (5) trucking, shipping or delivery, (6) local property taxes, (7) income, excise or franchise taxes, other than Federal, (8) license fees, (9) general or miscellaneous expense (itemized).

"Business expenses' do not include (1) wages, salaries or other compensation, (2) interest paid, (3) depreciation, depletion or amortization, (4) contributions or gifts, (5) pension, retirement, profit-sharing payments or bonuses, (6) bad debts, (7) losses, (8) advertising, (9) repairs, (10) legal expense, (11) insurance premiums, (12) accounting, (13) dues or subscriptions.

"The foregoing items are not necessarily exclusive, but are indicative of the character

of business expenses that may be used in determining the substitute percentage.

"5. This ruling shall take effect immediately and apply to all reports required to be filed on or after May 15, 1945 under Article 9-A of the Tax Law, as added by Chapter 415, Laws of 1944. Tax Commission Ruling, July 30, 1946."

The ruling appears simple and its implications not far reaching. It will affect such businesses as incorporated advertising and selling agencies and others operating without ownership of inventories or of fixed assets other than office furniture, fixtures and equipment. Under certain circumstances one of three factors in the prescribed business allocation formula, the property factor, may be eliminated and another factor, a business expense factor, substituted. The business expense factor rests upon the definition or description of business expenses contained in the ruling.

Elimination of the property factor will be made by the Commission on application of the taxpayer or by the Commission on its own motion. Upon elimination of the property factor the Commission may, in its discretion, substitute the business expense factor, or apply a two-factor formula. The ruling does not of course deprive the Commission of the power to make other adjustments to allocation, such as those specified in Article 415 of the Regulations issued under Section 210 (8) of the law. Under Article 415 the business allocation percentage may be adjusted by exclusion of a factor, inclusion of one or more other factors, exclusion of one or more assets and related income, or by application of another method of allocation calculation.

In many instances to which the ruling might appear to be applicable, the difference in percentages of the property factor and the business expense factor may not be significant, and hence neither the taxpayer nor the Commission will move to eliminate the property factor. Presumably the taxpayer will not apply to have the property factor eliminated unless it is both less favorable than the business expense factor

which may be substituted and less favorable than the two-factor formula which may, alternatively, remain. Except in instances where a substantial inequity would be done without making revisions, it is not to be expected that the Commission, after requesting information to ascertain that the only tangible assets owned are office para-

phernalia, will, on its own motion eliminate the property factor, thus leaving a two-factor formula, or a three-factor formula containing a business expense factor.

Taxpayers of the kind which may be affected should review their franchise tax returns which were required to be filed on May 15, 1945, or subsequently.

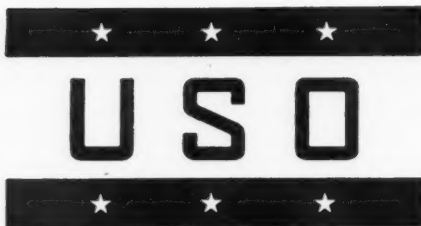


Arrangement of Current Files When Presented to Review Department

When the reviewer starts his work, a systematic arrangement of the papers is a major factor in determining the efficiency of the reviewer. The following suggestions have been given to us as to how the file might be arranged for this purpose:

1. Engagment record.
2. Notes to central office.
3. A written report (current).
4. Working-paper file.
5. Prior-year reports (including any interim reports of the current year).
6. Permanent file.
7. Engagment outline.
8. Dummy reports.

—Auditing Practice Forum,
VICTOR Z. BRINK, Editor,
The Journal of Accountancy,
August, 1946; page 155.



Random Thoughts of a Returned Veteran

By HAROLD E. MACFADDEN

I SUPPOSE every serviceman, upon receiving those letters from the office, pondered as to the prospects the profession would hold for him on his return to the States and, more particularly, upon confronting the staff personnel supervisor for their first peacetime chat.

Probably foremost in his mind was compensation. Didn't more than a few letters from staff assistants describe fabulous wartime salaries, fabulous compared with pre-war pay-rates? What could he expect to earn? What would he need to live in these United States for the first time in years, lacking knowledge of the cost of a luxurious white shirt, or a pair of wing-tipped civilian shoes? Certainly tempered complaints from the more seasoned managers and seniors testified to the long hours, and verified to his satisfaction that there existed a manpower shortage hitherto unknown to the profession.

Assignments, too, were a factor not to be overlooked, for the better assignment generally is the companion of the better salary. A few years of pre-war experience had ingrained in him the importance of this factor. But how could he hope to achieve a heavier staff classification when he knew war had taken away more than a few years from highly valued ex-

perience? He concluded that concessions would, of necessity, have to be made by principal, assistant and client.

Hours, admittedly long during the winter months, presented an astigmatic view of the profession to the veteran. Would he depart from home on those tedious out-of-town engagements, immediately following his return? Would there be those familiar deadlines to meet, for which the principal seemingly wielded the big stick over the field-man's head, while the client's interest lay only in the availability of figures?

How would the seasoned senior, accustomed to assistants selected under high pre-war standards, react to the work of the veteran eager to assume the responsibility of heavy engagements, when they mutually recognized the interrupting effect of military service upon staff experience? Would he be anxious to understand the veteran's problems, and eager to help in his re-establishment in a position warranting the payment of the living wage?

Then too, what acceptance of the returning former employee would there be by those men of military age fortunate (or unfortunate) enough to have missed service experience? Many of them had, in three or four years, progressed to heavy staff assignments. Others, in numbers, faced displacement by the exservicemen under the Servicemen's Readjustment Act. Here was a cause of friction and resentment not to be overlooked.

Lastly, the ex-serviceman wondered how he'd surmount the hurdle presented by the C. P. A. examinations, following a lapse of years in his accounting education and practice. The prospect of arduous preparation is a major one in itself, irre-

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spective of the other weighty problems confronting the man contriving to earn a living from a highly competitive profession.

Anxious to renew acquaintances with colleagues, the uniformed dischargee who returned to his first peacetime chat with the personnel manager, usually found the firm almost too eager to have him return. Following a brief resumé of his military experiences, the question first put to him usually is, "When do you want to start work?" The peak of the year-end audits was near and men of known reputation were desired. The personnel-shoe was still pinching. Good men were, as always, in demand. During the war, one man said a firm had actually hired a former handwriting expert, a professional magician, and an ex-rodeo cowboy to plug the breach in its staff of assistants! As a result, more often than not the man was urged to return to work immediately, and immediately meant foregoing those dreamed-of vacations of weeks of just loafing in the proverbial "state-side" manner.

The average veteran and former accountant, felt a sense of moral responsibility to his firm, and back to work he went.* He was usually pleased at the starting salary which he was offered. His pre-war experience had taught him that juniors usually were worth \$100-\$150 per month, semi-seniors \$150-\$225, and seniors anywhere beyond \$225. In fact, in those days a man often made extreme monetary sacrifices to obtain those few years of highly prized, practical experience necessary to qualify for professional examinations. The veteran had reflected upon living on those salaries in his particular pre-war classification and certainly viewed his successful return to the profession as slightly dismal unless his employer would meet him more than half-way. In more cases than not, practitioners wel-

comed former employees with increases above previous salaries ranging anywhere from thirty-five to seventy-five percent, depending of course, on the man himself and his promotional progress in military rank or rate. Even so, these increases the veteran soon learned, were only equal to his former salary in purchasing power, for in most cases the veteran had little idea of the heights that prices had reached or of the depths to which dollar values had shrunk.

With a relatively higher salary and a relatively higher staff classification the returned veteran found himself, almost too quickly, plunged into an assignment. He soon learned that supervisors were eager to lend him counsel on technical questions, and to stabilize his accounting judgment when required. When he requested help on current taxation his answers came willingly and painstakingly; the instant problem settled, helpful pamphlets of filled-in returns, regulations, etc., were passed on to him for perusal in less busy moments.

While on his first post-war engagement he learned that clients were happy to have him back despite his unfamiliarity with current problems; not infrequently his probing, born of ingrained inquisitiveness, brought forth new ideas on old problems. He recognized that the client's staff was receiving veterans into key positions and that they too were eager to cooperate, to the mutual advantage of accountant and client.

Those dreaded deadlines diminished in importance as a factor with which to contend. He recognized that clients had become accustomed to delays, due to wartime personnel limitations, and that the greater availability of post-war employees made the deadlines relatively easy to meet; and with a better quality of work than had been possible during the war years.

Working hours, long the bane of public accountancy, had improved considerably. Possibly because of the help given by supervisors and the cooperative attitude of clients; possibly because his military hours had, at times, been nothing but non-productive waiting. The combined effect, whatever the casual factors, was a happy one. The accountant found himself with winter holidays, Saturdays off, and many of his evenings free. As a result, when necessary and required, he worked late with a greater willingness than appeared in his pre-war memory.

Probably the most difficult undercurrent to overlook was the non-veteran newcomer who had progressed rapidly to relatively heavy assignments in three or four years. Proven ability notwithstanding, friction was present. Many of these men treated the veterans with an unwelcome reception; perhaps this was because they sensed a possibility of displacement by the veteran. Some of them considered the experienced veteran as a neophyte, and were surprised to find years of accounting responsibility adequate testimony to the veteran's present staff position. Whatever these undercurrents, the veteran found these men to be capable, eager to help, and at times entertaining. It seemed strange that any man of military age could not distinguish between a 45 Colt automatic and a 40 millimeter A.A. weapon; no doubt the non-veteran enjoyed our inability to recognize a renegotiation contract or a carry-back.

As for women accountants, the veteran found himself almost too happy to tote adding machines or bags crammed with work papers for her. After all, hadn't he seen the day when he wished that he had been within five hundred miles of a white woman? Here she was, and with shoes on too!

State legislatures were considering various preference bills, designed

to aid the veteran in obtaining the muchly desired certificate. Some would award the highly prized certificate without the requisite professional examinations; others would credit the serviceman with any military service in fulfillment of experience requirements; still others would recognize only such military experience as was of an accounting nature. When the news of such propositions reached the ear of the qualified veteran-C.P.A. candidate, he found it unbelievable. Among other things, he had made costly sacrifices in time, energy and salary in the acquisition of necessary experience and educational qualifications. Was all this soon to be voided? Was the profession to permit the worth of the certificate to shrink by the relaxation of the high standards which, through the years, have elevated accountancy to a place among the professions?

While it is not unreasonable to assume that a qualified accountant could have passed the examinations in three or four years had he not been in military service, it must have been welcome news to him to learn that the American Institute and various state societies had adopted resolutions recognizing his problem, but advocating the continued maintenance of the prerequisite high professional standards basic to the issuance of a certificate. As many ex-servicemen await the results of the May, 1946, Uniform Certified Public Accountant Examinations, and as many more prepare for those to be held in November, it is a tribute to the profession that we are closer to 100% national uniformity than ever before.

Under the G.I. Bill of Rights, the candidate almost immediately upon discharge, plunged into various refresher courses. Gratifying as it was to see hundreds of ex-servicemen with a common singleness of purpose, it was satisfying to know that the standards had been kept high.

With most veterans eager to pursue advanced study, the firms, the profession and, of course, the individuals, stand to gain to mutual advantage through wise cooperation by all parties.

If the returned serviceman was placed in charge of an engagement he might find that some novice assistants did not have a full appreciation of the long overtime hours necessary in pre-war days to accumulate that thing called experience, that many of them viewed the profession as stepping-stone to a private, corporate accounting position and that, as a result, they did not enthusiastically pursue public accountancy as a career embodying a high degree of technical excellence and a willingness to work. This probably was the result of wartime practice, which saw numerous practitioners foregoing the profession in favor of high paying executive positions in private enterprises. In fact, more generally than not, few men engaged in public practice looked to a professional future with their respective firms, but hopefully anticipated the offer and acceptance of a position in private enterprise.

What can be done to make the profession inviting to newcomers and returned veterans? One factor is to welcome the younger men to the various societies' meetings. The veteran is accustomed to active participation in major undertakings. By invitation to these meetings and accounting forums, he will feel more a part of the profession, which admittedly or not, needs enthusiastic practitioners to maintain the progress already made. Particularly members of staffs of the larger firms feel this need.

Such a pamphlet as "Public Accountancy As A Career," which con-

tains enough information to keep potential applicants for staff positions aware of the requirements and opportunities offered, accountancy should be distributed to all students of the subject.

Often guilty of dormancy, the result of conservative firm policy, the staff member of the larger firm feels he is just another berry in the pie. Such organizations might do well to insure the maintenance of career men on their staffs by monthly meetings of the organization during which participation of young men is encouraged. News letters of current interest, technical and not, have been found to inspire interest and broaden knowledge of young men eager to learn but often lacking the facilities or material. Education in the field is excellent, but all too often the less experienced accountant misses the learning when the in-charge man is in a rush to complete the engagement. A more definite plan of in-service training is needed.

The thoroughly experienced men, those already committed to a career in the practice and who have met with success in their chosen work, can be of inestimable help and a welcome source of guidance to young men, if they would undertake to volunteer their services as running mates in professional activities. Friendly, advisory talks by managers with staff members develops confidence and does wonders in building an *esprit de corps* so vital to the progress of any organization.

In conclusion, the writer states that this is not intended to be a scholarly work, but rather thoughts collected at random from conversations and experiences since his return to an improving and satisfying profession.

The Taxpert Travels

By LEWIS GLUICK, C.P.A.

A GREAT many years ago I wrote an article on hints to travelers. Much of what was in it is still good, but the modern mode of travel by air calls for bringing it up to date. Many taxperts have yet to experience the pleasure of air travel; and some of those who have, may add to the pleasure of the next trip by reading this.

My first air trip was in the summer of 1934, in an open cock-pit Navy plane, from Anacostia to Brooklyn. A medical officer prepared me against air-sickness with a pre-dawn dose of magnesium sulphate. The flight was a complete success for me. Two years ago I traveled by air from Naples, Italy to New York, by a most circuitous route, necessitated by the war. In the modern, fully enclosed planes, no thought was given to air sickness, and what's more, I didn't see one case of it; even on a flight, a month later, from Virginia to California, over some bumpy mountains. Super-modern commercial planes are even less likely to cause travel distress. Yet there remains the inevitable small percentage, well known to naval medical officers, whose ear canals just do not function perfectly. Seasick, train-sick, or air-sick, they are poor passengers.

I know nothing of some of the medication advertised as "cures". But I do know that for any person liable to sickness, the pre-flight cleansing, as prescribed in 1934, plus light eating en route, is most helpful.

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To me, the one great, and at times controlling, drawback to air travel, is the limitation on baggage. It's all very well to take a light bag for a short trip. But an auditor usually cannot finish an engagement within the limits of the contents of that bag. Time was when you could get 24, or even 12, hour laundry service at a good hotel. If you had two shirts, two suits of underwear, three pairs of sox, and as many collars, you could get along quite well. "Them days" may not be "gone forever", but they surely are slow in returning. The taxpert, being a professional man, *must* look neat at all times. How can he accomplish this and still enjoy the speed and convenience of air travel?

Well, for one thing, if he makes repeated journeys between two points, he can keep a reasonably complete outfit at the out-of-town point. For example, I may send someone some gear to stow for me in Washington against any trips I have to make there, but first I must get the shirts, shorts and sox, not to speak of a new shaving brush. The second, more usual method, works only if the trip is scheduled well in advance. In that case, a bag or trunk is expressed ahead, to the hotel where reservations have been made.

But too many trips are made impromptu; a sudden call. What then? If the expected stay is to exceed a week, a trunk expressed to follow the traveler may arrive in time to give him some clean clothes to fly home in. Otherwise he must just trust to luck.

Of course, old Navy men like me are not bothered by underwear and sox laundry. We learned how to do our own in "boot" camp; and it's an art well worth knowing. Therefore, I concentrate on shirts and collars, and, if a two-pants suit is

The Taxpert Travels

available, get along quite well. In California you need not fret about the coat and trousers matching. The style here prefers them contrasting.

It isn't only clothing, however, that you must consider. No matter what mode of travel you use, you must provide for contingencies or emergencies. For example, don't wear old shoes. Wear shoes, which, if not brand new, have solid soles that will not wear out while you are away. Wear black ones, which are suitable for all occasions, even if you have to hire a dinner-jacket. Take a pair of rubbers. They weigh much less than a pair of shoes; wear the rubbers when there is rain or snow; if your shoes don't get wet, you won't need to change them. Stuff the rubbers with such bottled stuff (mouth wash, hair tonic, etc.) as you carry, and your spare sox. That saves space, and guards against breakage.

But you may catch cold, eat too much, or the wrong things, or what not. Be sure that you have your favorite remedies in your bag. The attack may come at three A.M. I have a little first-aid box, 6 by 8 by 2½ inches, and the quantity of stuff it will hold is amazing to the uninitiated. It's been everywhere I've gone for the past ten years, and some of its contents have never

been touched, thank goodness. On the other hand, once an item is invaded, replace it promptly, and for some items, even though untouched, beware of deterioration. As to drugs, consult your physician.

First-aid is not always a matter of pharmaceuticals. My kit includes two needles, threaded one white, one black. It's a heck of a note if the top trouser button pops while you are dressing in a Pullman. Also, I have a pair of shoe laces, a spoon to take medicine I hope I won't need, and a few other little items, mostly from dime stores, that you'd give dollars for in a pinch. Each traveler must decide on what he needs, based on his experience and idiosyncracies. The essential thing is to *have* them.

Another point is to carry a slicker. It will double nicely as a bath-robe; but the finest robe made won't keep you dry when a thunderstorm comes up. When the suit you are wearing is the only suit you have that's important.

One last word about professional equipment. The luggage people have really done wonders in providing luggage of low weight and high strength for plane passengers. But I have yet to see audit bags designed for air-travel. Isn't it about time we had them?



PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

How the Accountant Can Help Charitable Causes

Once again, with the advent of the fall season, various charitable drives and undertakings are being organized which will require the greatest amount of help from all public spirited members of the community.

Community Chests and Councils, Inc., has prepared a booklet entitled, "Your Taxes and Your Contributions", which reminds business firms and individuals of the deductibility of gifts to Community Chests and to the U.S.O. Copies of this booklet may be obtained from the Community Chest in your city or from Community Chests & Councils, Inc., 155 E. 44 St., New York, N. Y.

Since Community Chests, this fall, will be seeking \$160,000,000 to finance 10,000 health and welfare agencies, and U.S.O., in its last campaign, is seeking \$19,000,000, it is essential that all possible help be extended to these two worthy causes.

Accountants, who have been known for their liberality in charitable causes, are urged to give their fullest possible cooperation in this connection.

Inventory Pricing

An interesting review of the current thinking on the subject of Inventory Pricing appears in a paper by Edward J. McDevitt, C.P.A., in the Bulletin of the Massachusetts Society of Certified Public Accountants, Inc., for September, 1946.

In this article, Mr. McDevitt reviews the research which has been going on with respect to the subject of inventories, more particularly under the aegis of the subcommittee of the Committee on Accounting Procedure of the American Institute of Accountants.

He notes that basic to the entire thinking has been "a general acceptance of the shift of emphasis from the balance sheet, as the financial statement of principal importance, to the income

statement". As a corollary, he says that "the former recognition of conservatism as a virtue in inventory valuation has disappeared, for the very evident reason that the understatement of values at one date results in overstatement of income in a subsequent period", and therefore concludes that "the primary basis of valuing inventories is cost but only to the extent that such cost is deemed to be properly allocable against revenues of ensuing periods". In other words, he believes that the cost basis of inventory valuation should be subject to the limitation that it be not in excess of that portion of cost which can later be recovered in the market.

The author then proceeds to investigate the various methods of costing and the problem of the determination of what is market value.

In the latter connection he notes the difference in the thinking between the American and English schools of thought. The former seems to favor an inventory realization value calculated *after* the deduction of a profit margin, whereas the English group generally recognizes market value as being realizable value *without* allowance for profit.

Another point discussed in the article is the matter of whether the cost on market rule should be applied to each item in inventory, to the totals of the inventory, or to the totals of the major categories of the inventory. The author expresses the opinion that the consensus among practicing accountants would seem to favor the application of the cost on market rule to the totals of the major categories of the inventory, with exceptions noted where the application of the rule might produce an inequitable result.

Authoritative Financial Accounting

Once again, George O. May, whose writings are undoubtedly familiar to all of our readers, presents a most inter-

esting article (The Journal of Accountancy; August, 1946) which describes financial accounting as it exists today, tracing its development, outlining its objectives, and indicating its usefulness to society both now and for the future.

The importance of accounting in today's economy, says Mr. May, requires no demonstration. He points out that rules of accounting become, in effect, rules of law; that, within wide areas, value is recognized as being dependent upon income; that the measurement of income is an accounting process; and that changes in accounting methods may easily result in changes in property values.

Financial accounting is a comparatively modern art and its practice a comparatively new profession. The typical products of the practice of this profession are the annual corporate income statement and balance sheet. It was recently held by the S. E. C. that the practice of this art is essentially historical in nature, although accountants also believe their function to include the interpretation of these facts in a proper perspective.

Conditions have changed since accounting has grown up as a profession, and Mr. May notes that one of the most monumental changes in the development of accounting to meet these changed conditions occurred in the year 1932, when the American Institute of Accountants and the New York Stock Exchange agreed upon a rather startling shift in accounting outlook, accepting the view that accounting is governed by conventional rather than natural laws and that the test of acceptable accounting is its social usefulness. Three modifications of emphasis were recognized:

- (1) from the balance sheet to the income statement;
- (2) from value to cost, or "useful" cost; and
- (3) from conservatism to consistency.

Mr. May discusses, *inter alia*, such interesting problems of accounting theory as the treatment of discount on bonds that remain unamortized at a date when an issue is retired through refunding operations, together with the relevant income tax implications; the function of footnotes in the preparation of statements; the concept of original, or rather "aboriginal" cost; the amortization of good-will and other intangibles; and the like.

As for the financial accounting problems of the future, Mr. May suggests that attention will probably be given to problems involving the stability of the monetary unit; a continuance of the emphasis on the income statement, leading to a much more searching analysis of what constitutes income; a greater emphasis upon cost; a continuance of the emphasis on consistency; and a general reconsideration of the concept of the nature of capital stock.

Mr. May believes that while regulatory bodies have an important part to play in the development of the field, nevertheless "accountants themselves feel that new rules or precedures should first win the approval of those whose authority rests on professional skill, experience, and judgment and the function of those whose authority rests upon law should normally be exercised to encourage the adoption of and in due course to assist in the enforcement of principles and procedures which have secured that approval. In this manner it should be possible to arrive at accounting principles and accounting procedures that will be generally accepted and will be authoritative in every sense."

Prospective Revisions in Accounting Technique as a Result of Changing Economic and Social Forces

Those of our readers who were impressed by Col. Berylson's article, "The Accountant's Role in Industrial Relations", which appeared in our June, 1946, issue, should also be interested in the above-entitled article by Hubert

Professional Comment

Stanley, a Missouri Certified Public Accountant, which appeared in the August, 1946, issue of *The Canadian Chartered Accountant*. Among the other things discussed by Mr. Stanley in his paper, he points out that one of the most important factors affecting our present economy is that of labor, and that this factor will have a very profound and increasing effect upon the accounting profession and our future accounting techniques.

Mr. Stanley makes the point that, whereas in the past the financial statements included in the annual report to stockholders and others have been prepared without regard to the effect upon labor, in recent years, however, many of these reports have been placing more emphasis upon the employee aspect of financial reporting and have been addressed to both the stockholders and the employees. He criticizes the advisability of issuing two different forms of income account—one for stockholders, and one for employees. He believes that the employees are fully capable of comprehending the usual form of income statement and that in this transitional stage, at least, perhaps the better thing to do would be to furnish all necessary information combined in one report.

He also points out another aspect of the income account which should be carefully considered in the light of the importance which labor is assuming in the problems of business management. That is a matter of differentiating the items chargeable to the income account and to surplus. Mr. Stanley points out that many contracts exist in labor and management relations which are based on profits; and the question of what are profits is, of course, influenced by what items are included in or excluded from the income account.

Accounting in a Decentralized Organization

Alexander MacGillivray, the Director of Accounts and Finance of the RCA Victor Division of the Radio Corporation of America in Camden,

New Jersey, makes out a good case for decentralization of the accounting function in a very illuminating article which appeared in Section I of the September 1, 1946, issue of the *N. A. C. A. Bulletin*. Therein, he relates in detail the experience of his organization under this arrangement and indicates his belief that there is already ample evidence to show that the system can work smoothly and effectively and bring about the benefits that have been predicted for it.

The experience of his company indicates that although accounting costs might tend to rise in a decentralized set-up, nevertheless, these increases are by far offset by the greater contribution that the product (divisional) controllers can make to the success of their respective departments' operation. Having a greater familiarity with the departments and their respective problems, they are in a position to concentrate on the problems of their units much more effectively. Nor will this set-up result in their devoting their time exclusively to the accounting aspects of the work; rather is it the case that they will work more closely with the manufacturing, engineering and sales divisions of the product and, thereby, achieve substantial benefits for the entire organization.

Another advantage lies in the fact that decentralization makes it possible for more men to assume controllership responsibility, thus affording greater opportunity to the personnel and providing them with a greater personal incentive. This Mr. MacGillivray believes, should ultimately result in expanding the market position of the company, maintaining the quality of its product, and attaining worth-while profit results consistent with stockholder responsibility.

Steamship Accounting

In a most interesting article appearing in the August 1, 1946, issue of the *N. A. C. A. Bulletin*, Arthur B. Poole, Vice-President and Treasurer of American President Lines, Ltd., dis-

cusses the special accounting problems and techniques of subsidized steamship lines based on the procedures in his own company, which was one of the few steamship companies that, before the war, combined both domestic business with a subsidized foreign business. Its accounting problems and techniques, therefore, necessarily include those of both types of business.

The paper is limited to a discussion of steamship accounting as it is normally carried on commercially during peace-time operations, and the subject is considered under four topics:

1. Accounts related to operating statements.
2. Accounts related to the balance sheet.
3. Steamship accounting methods and procedures.
4. Steamship cost accounting.

A few of the highlights of steamship accounting which differentiate it from accounting as it is likely to be found in other industries, include the following items:

1. The accounting unit of operations is the terminated voyage, and all costs are stated on this basis.
2. The problems of assembling promptly the revenues, expenses and related data for each voyage are quite complex.
3. An understanding of the Merchant Marine Act of 1936 is necessary if one is really to understand the concepts of the operating - differential subsidy, the construction-differential subsidy, capital reserve funds, and the like, which are peculiar to the steamship industry.
4. The terminology, form and evaluation practices of subsidized steamship companies are generally consistent with each other; not so, particularly, with non-subsidized companies.
5. The taxation problems of subsidized steamship companies are at

great variance with the ordinary federal taxation of general corporations.

6. The problem of payrolls is highly complicated by reason of federal statutes, collective bargaining and established steamship practices.

The article is interesting because it describes a most important industry, whose operation requires a particular kind of accounting suitable to its own problems.

Responsibility Accounting

Ralph B. Knott, a member of the firm of McKinsey & Co., recently read a paper before the Pacific Coast Conference of Controllers in San Francisco which presented a very significant viewpoint. It was published in the August, 1946, issue of *The Controller*.

Responsibility Accounting — the method by which the accounting procedures are tied in directly with the unit responsibility of executives and supervisors—is, in his opinion, an important phase of corporation accounting.

If every individual with authority can be charged fully with responsibility for results and is furnished with data which will facilitate the improvement of the activities under his direction, a program can be evolved which will develop cost consciousness and a sense of proprietorship in each executive and supervisor and instill in him the feeling that he is an important member of the managerial team.

Basic to this program is the necessity of recognizing three underlying steps:

1. Classifying the activities into the proper units of organization.
2. Devising the means by which the necessary information is collected for each such unit.
3. Presenting the information in reports that will be easily understood by the person in charge of each unit so as to enable him, in fact encourage him, to take action based thereon.

Mr. Knott discusses the means whereby the proper units of organization may be established, and presents check-lists to guide in the determination of the soundness of organization structure and the propriety of the organization chart.

In order to provide information to the organization units, the author advocates the use of a chart of accounts which will supply data from both the operating and financial points of view. He calls for the use of a standard practice manual outlining the accounting plan, which will provide uniform interpretation, standardization of procedures and, also, serve as a guide for the supervisory staff who normally do not have an accounting background.

The reports to management should be so designed that not only are they technically perfect and accurate and sound from a financial accounting viewpoint, but they are adequate from the point of view of meeting the needs of the operating executives to whom they will be presented for use. Mr. Knott states that since each major department undoubtedly has a different problem, the techniques used for control should be devised to meet the specific needs of each unit and should include the following operating controls:

- a. Cost accounting.
- b. Budgetary control.
- c. Sales control.

Cost accounting, of course, is necessary so that effective control may be obtained by classifying the costs in terms of the organizational unit responsible for their incurrence. However, the system of cost accounting adopted in any particular case will, of course, depend upon the local situation.

Budgetary control is necessary as an effective means whereby plans for the future can be translated into estimates of future income, costs and expense, and ultimately used as a basis for checking the forecast against the actual operating results. Budgetary control thus provides an effective and practical

means of determining in advance the factors which are ultimately productive of profits. It will facilitate the prompt taking of corrective action as soon as the comparison of actualities with the planned budget indicates that the anticipated results are not being obtained.

The last point considered is the development of controls over the function of sales and distribution; in this connection, the author indicates five basic reports as a minimum for a normal sales report pattern.

It is Mr. Knott's belief that responsibility accounting, as he envisages it, is the way to provide business with highly usable controls to meet the responsibility of management in the light of changes in markets, material and methods in the post-war period.

Study Outline—

Developing Basic Cost Information For Material and Labor

A very useful manual, in outline form, for use in discussion and study group programs interested in the topic noted above, comprises the third section of the September 1, 1946, issue of the N.A.C.A. Bulletin.

It outlines a course intended to cover 8 sessions as follows:

1. Organization for Collection of Basic Information.
2. Incoming Materials Data.
3. Material Issues.
4. Special Material Problems.
5. Labor Costs.
6. Special Problems in Labor Costing.
7. Production Data and Product Costs.
8. Monthly Closing and Material and Labor Reports.

After outlining the scope of the material to be investigated and studied under these headings, each section contains a group of selected readings pertinent to the subject matter under consideration. These readings are from

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current source materials and are both authoritative and to the point.

In the 131 pages of this booklet there has been included a review of the subject matter that will be of interest not only to private study groups, but also to regularly enrolled students of cost accounting.

A Return to Cost Control

The Pennsylvania Regional Cost Conference, which was held on April 6, 1946, in York, Pennsylvania, had as its central theme the foregoing topic. Three papers were presented at this conference and have since been made available to the members of the N.A.C.A. and the general public in booklet form.

The first of these was entitled, "The Control of Prime Cost at Operating Department Levels." It was read by Mr. C. E. Headlee, Director of Industrial Accounts, Westinghouse Electric Corporation, Pittsburgh, Pa. The second paper was entitled, "The Control of Direct Expenses of Operating Departments," and was presented by Mr. Jesse G. Kline, Chief Cost Accountant of the Atlantic Refining Company, Philadelphia, Pa. Lastly, a paper on the subject of "Revitalizing Standards For Control of General Expenses" was delivered by Mr. Edward J. Hanley, the Vice-President, Secretary and Treasurer of the Allegheny Ludlum Steel Corp. of Brackenridge, Pa.

Thus, in this booklet, the subjects of prime costs, direct expenses and general expenses are considered in their relation to the central theme of "A Return to Cost Control."

Research and Development Cost Control

The American business man is notorious for his vital interest in research and development of new products. He is always eager to utilize to the fullest extent the scientific knowledge which is extant in order to attain the greatest profit for the company in which he is interested. Toward this end, many

companies have or are presently establishing research divisions, while others are expanding the scope of this type of activity. Still others are beginning the exploration of methods by which they might keep abreast of the advances in the field of science and technology.

Ronald H. Robnett, Associate Professor of Accounting and Fiscal Officer of the Division of Industrial Cooperation in the Massachusetts Institute of Technology develops this idea in an interesting article entitled "Control of Research and Development Costs," which appeared in the July 15, 1946, issue of N.A.C.A. Bulletin.

After considering various aspects of the problem which he has under consideration, Professor Robnett discusses the methods of accounting for research and development costs based on the procedures in force in a particular organization of considerable magnitude. He covers the budgeting and accounting procedures for research costs from the viewpoint of utilizing them to control complex research and development activities in an effective and internally harmonious manner.

Merchandise Planning and Control

It is generally well recognized that the primary functions of the retail store and the chief factors in the production of its income are those of buying and selling merchandise. During the war years, the problems of control of merchandise were not so important because of the fact that it was a seller's market and the main problem was principally getting enough merchandise to satisfy the demands of those who were seeking to buy it, rather than to control merchandise stocks against the possibilities of over-buying.

In an excellent paper by Leonard C. Hobert, Assistant Controller of Gimbel Bros., Inc., Milwaukee, Wisc., published in the July 15, 1946, issue of the N.A.C.A. Bulletin, we find a brief presentation of that part of department store operations which has to do with merchandise planning and control, in

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recognition of its renewed importance.

The article begins with a section on Merchandise Planning. It defines the merchandise plan as "a forecast of future operations designed to obtain in advance an idea of the sales within a given period of time, and the value and quantity of merchandise inventory needed at all times to realize these sales." It then proceeds to consider merchandise plans for each of the following items: sales, inventories, purchases, mark-on percentage, mark-downs, and gross margin.

The next section of the article deals with the topic of Merchandise Control and points out that in order to control the merchandise inventory properly, it is necessary to begin at the beginning, namely at the time the orders are placed, and to follow through the actual receipt, checking, and marking of the merchandise and the payment of the invoices. Stock records or book inventories, of course, are constantly checked against physical counts of the merchandise by departments at the predetermined periodic intervals. This section also develops the subject of inventory dollar control-retail method, unit stock controls, and the taking of physical inventories.

The article is recommended to those who wish to get a quick bird's eye-view of the manner by which department stores plan for and control their merchandise inventories.

What Is a Practice Worth?

Those of our membership who have been following with interest the activities of our Committee on the Administration of Accountants' Practice will doubtless recollect their difficulty in formulating an answer to the question, "What is a Practice Worth?" As a matter of fact, the Chairman of this Committee has on several occasions reported that while he has made earnest attempts to elicit factual information that would be helpful to the solution of this problem, he has, nevertheless, been unable to find any practices which were actually offered for sale.

One of our English brethren, Mr. John R. Lane, A.S.A.A., has written on this subject in the May, 1946, issue of Accountancy, the Journal of The Society of Incorporated Accountants and Auditors in London. His article was also reprinted in the June, 1946, issue of The Indian Accountant and Secretary.

The first question posed under the general problem is, "What is an economic purchase price?" Mr. Lane correctly states that there can be no hard and fast rule and answer to this question because it varies with the individual case, particularly since one does not purchase the clients but only the contact with them and the possibility that they may continue the services of the purchaser of the practice. However, he points out, that the preliminary factor which would be determinative in a particular case in the net annual income from the practice, before taxation, and he suggests that this net annual income must be at least equal to the sum of three factors:

1. What would be earned in comparable employment.
2. Interest on any capital outlay involved in the purchase.
3. A reasonable return for the assumption of the managerial function in the running of the practice.

He observes in connection with this question that a practice consisting of a large number of small engagements would probably be more attractive than one composed of a small number of large jobs. He suggests that, before negotiations are concluded, the purchaser of the practice ascertain the age and type of the practice offered, the reason for selling it, and the most recent net annual return received by the prospective vendor.

The next factor involved in the general question is what the basis of the purchase price should be; that is, shall it be based on net profit, on gross fees, on gross recurring fees,

or on what the author calls the "super-profit basis". The author believes that the gross recurring fees basis most nearly meets the requirements of fair dealing on both sides. In this connection, it is important to define in advance the fees which are to be considered as recurring fees. Several possibilities exist: Those which have existed (a) for a lengthy period, say ten years or more; (b) an intermediate period of between five and ten years; or (c) an initial period of less than five years. Other important points to be considered in connection with the foregoing are, first, the extent to which fees are dependent upon large engagements, the loss of any one of which would seriously affect the practice and, second, which fees might conceivably cease within a few years because the engagements producing these fees are likely to be permanently concluded. Then there is the factor that some of the fees may be produced by the kind of work which the prospective purchaser would not wish to continue, as, for example, secretarial work, "write-ups", and the like.

Mr. Lane suggests that an excellent way to consider the trend of profits is to plot them on a graph for as large a time period as is possible (for at least ten years), so that the effect of the pre-war period may be noted and evaluated in this connection.

When all factors have been ascertained there remains the problem of determining a fair purchase price. The view of the writer of this article is that the number of years purchase should range between a minimum of 1 year and a maximum of 2.2 years. He states that while it is true that a purchaser might be willing to work on a smaller return at the outset of the assumption of a new practice, in his opinion a price of more than twice the gross recurring fees does not appear to be easily justifiable, particularly since the present sellers' market may shortly cease and the income of the practice be seriously impaired.

Inflation, Price Control and Taxation

Under the foregoing title, Professor Harley L. Lutz presents a very interesting viewpoint in the August, 1946, issue of *The Tax Review*, published under the auspices of the Tax Foundation. In this paper Dr. Lutz attempts to show that our current situation is not hopeless and that the popular concern about inflation may be alleviated and the future of prices solved, if one possesses a correct understanding of the real difficulty and applies the proper remedy.

At the outset Professor Lutz points out that the root of the trouble is the great increase in purchasing power. Taking as a measure of this increase the growth of bank deposits and currency, he points out that between December 31, 1940, and May 31, 1946, some 5½ years, one hundred billion dollars was added to the nation's supply of money and bank deposit credits. This, he asserts, is a permanent addition and will remain so unless and until it can be reduced through the process of debt retirement. It is the inflation of credit, he says, that has produced the effect we now experience with respect to prices and incomes.

Dr. Lutz notes that this huge expansion in purchasing power may also be expressed in terms of the national income. Thus, comparing the calendar years 1940 and 1945, he shows that the total national income has increased by about 107 per cent on an over-all basis. The largest shares, namely the compensation of employees and the net income of proprietors, rose approximately 127 per cent.

The real pressure on prices depends on the quantity of available purchasing power and the rate at which it is used and Professor Lutz indicates that, for the country at large between the years 1940 and 1945, the annual rate of turnover of demand deposits, excluding interbank and government deposits, has declined about 15.8% whereas, for New York City, it appears to have in-

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creased some 24.5% during the same period. He attributes the rise in the New York turnover rate to the growing influence of the prolonged stock market rise and the great increase in the scope of the trading.

As a final aspect in this statistical summary he considers the course of prices and, in terms of index numbers, he points out that between the year 1940, and the month of May, 1946, the increase in wholesale prices for all commodities, together, has been 32.4%, whereas the increase in all items in the cost of living, taken together, has been about 31.3%.

He concludes significantly, that a comparison of the changes in the national income with the changes in wholesale prices indicates that the former has risen relatively much more than prices.

The data presented by Professor Lutz disclose that we have created during the war years a vast number of dollars and that, as a result, each outstanding dollar is worth less in relation to goods and services of every kind, as indicated by the statistics with respect to prices and the cost of living. What to do about restoring the value of the dollar is the subject of the rest of this paper.

Several possible lines of action are mentioned: one would be to diminish, by some *tour de force*, the total number of dollars now in existence. Several methods of accomplishing this have been suggested but Dr. Lutz believes that this is a most drastic step and our situation is by no means so far out of hand as to warrant this course of conduct. Another line of action indicated would be to give all people more dollars by increasing the money income all the way around. It seems almost obvious to Dr. Lutz that this would be carrying us even further from the primary objective. A third line of action would

be "to effect a revaluation of the dollar in relation to goods by producing more goods at lower unit costs." Professor Lutz believes that the real way to raise the standard of living is to bring back the purchasing power of the dollar, and he says that a correct and sensible policy with respect to wages is to relate them to efficiency and productivity and thus to share the fruits of technological advance with all. He believes that for the accomplishment of this goal, price control is unnecessary and that it may even be a positive hindrance. His argument is epitomized in the form of this dilemma: If the price ceiling is fixed high enough to return production costs and a reasonable profit, then the operation of a free market economy would ultimately stabilize that price without the need of a ceiling; but if the fixed ceiling price is set below that point, then there is no production, at least for sale in the legitimate market.

With respect to the place of taxation in the general plan to restore the economy, Professor Lutz believes that it is always proper to maintain taxation at a sufficient level to cover expenditures and to provide, except in most unusual circumstances, for a systematic program of debt retirement. He does not believe that an increase in taxation at the moment would do anything toward curbing the inflationary potential which already exists, except to the extent that any tax monies would be applied toward the reduction of bank holdings of public debt and, provided further, that the bank does not offset this decline of deposits by expanding private loans.

Professor Lutz believes that there is no escape from the conclusion that the taxing power can be safely used only for the purpose of financing governmental needs, that all attempts to use it for non-fiscal ends will backfire or miss fire, and that this is also true of taxation as an instrument of the control of inflation.

BOOK REVIEWS

Principles of Accountancy—Advanced (Third Edition)

By H. A. Finney. New York, PRENTICE-HALL, INC., 1946. xi + 802 pages. \$6.50.

This book is written for students of advanced accounting—and by its coverage it is admirably adapted for those planning to take the C. P. A. examination. However, in a sense, this volume is more than an accounting text—it not only delves into the broader aspects of business but undertakes to correlate accounting treatment with legal requirements where the latter is a factor.

The material in this revised edition is presented in Finney's usual clear, concise and direct manner. His free use of explanatory case material facilitates understanding of complex subjects. If you disagree with Finney's conclusions you will generally have the benefit of knowing exactly why—because his conclusions are usually given only after presenting in logical form his reasons for them.

This third edition consists of 30 chapters taking 570 pages, followed by 222 pages of questions and problems arranged by chapters, and an 8 page index. Ten chapters are devoted to parent and subsidiary accounting and consolidated statements, three chapters to partnerships, two chapters to estates and trusts and one chapter each to consignments, venture accounts, installment sales, insurance, correction of statements and books, the statement of affairs, receiver's affairs, realization and liquidation report, home office and branch accounting, foreign exchange, budgets, public accounts, bank accounting, stock brokerage and consolidations, mergers and financing.

It is interesting to note that the chapters on consignments and in-

stallment sales which were omitted from the third edition of Finney's intermediate text now appear in this advanced text. In rearranging and selecting material for the advanced text he has also shifted two of the five chapters on partnerships from the advanced to the intermediate course and reduced from three to one chapter (and about one-half the number of pages) the material on foreign exchange. A new chapter concerning the correction of statements and books has been added.

Probably many accountants will not see eye to eye with the author's theory regarding the preferable method of recording and carrying on the books of a parent corporation its investments in subsidiaries. Mr. Finney explains in some detail the two bases for recording such investments and describes them as (1) the economic basis (maintaining the investment in subsidiaries at book value) and (2) the legal basis (maintaining the investment at cost). The author apparently favors the economic basis believing that it conforms to the "economic reality" of recognizing in the parent's accounts the periodic increase or decrease in the net worth of the subsidiary while the legal basis "often places the parent in a position to show as annual income such amounts as it may arbitrarily decide to have transferred to it as dividends, instead of the profit or loss which results from the subsidiary's operations." Accounting students would obtain a better conception of this subject if the author mentioned that a very high percentage of parent corporations maintain their investments in subsidiaries at cost (the legal basis). Reference might also be made to bulletins dealing with consolidations issued by the American Institute of Accountants, rules promulgated by the S. E. C.

and The Public Utility Holding Company Act of 1935 to throw further light on this question.

No matter whether you agree or disagree with Mr. Finney concerning the above, it does not impair the value of his text because he has discussed both sides of the question. In general, his presentation of parent and subsidiary accounting and the preparation of consolidated statements is excellent.

For the most part the specialized subjects dealt with in this book are very adequately covered but further expansion seems desirable in the chapters concerning bank accounting, stock brokerage and foreign exchange. Students having no knowledge of these fields would indeed find it difficult to reconcile the theory given in these chapters with methods and procedures found in actual practice.

In reviewing this book emphasis has been placed upon its use as a text book for students of advanced accounting. The reviewer wishes to go on record that he is not a teacher and consequently does not feel qualified to pass upon this book from the point of view of the teacher. However, the book seems particularly well suited to the needs of students and should be of considerable help and interest to them. The broad and logical approach to each subject should cultivate in students a similar perspective towards accounting questions. Any accountant whose work encompasses the specialized subjects considered in this book should find a space for it in his library.

RAYMOND G. ANKERS

Professional Ethics of Public Accounting,

By John L. Carey. New York, AMERICAN INSTITUTE OF ACCOUNTANTS, 1946. 136 pages. \$2.00; 25% discount to educational institutions.

For the good of all concerned in the

practice of any profession, including accountancy, it is necessary that the members thereof do more than discharge their legal duties to one another and those whom they serve. They must observe the rules of professional conduct, or canons of ethics, accepted by the profession as the basis for self-regulation not only in the public interest, but in its own self-interest. In essence, these require the professional practitioner to deal truthfully and fairly with the public, with his clients, and with his colleagues. Above all else, a professional person must possess the ability and perseverance to ascertain the truth, as well as the zeal and resolution to report it accurately and completely.

Mr. John L. Carey, the author of this book, is well qualified to write on the subject of this text by reason of his long association with the American Institute of Accountants, the national professional accounting society, as Secretary, and Editor of its Journal. His book does more than restate the rules of professional conduct; it discusses and explains them in a very real and practical way, illustrating the commentary by reference to recent opinions of the American Institute of Accountants' Committee on Professional Ethics, as well as to similar pronouncements of the S.E.C. and the Treasury Department.

The sixteen rules promulgated by the Institute to govern the professional conduct of its members have been regrouped for consideration in this book according to their purposes and importance.

The first section of the work deals with the rules designed to protect the public interest. The underlying basic concept in this area is that of the independence of the public accountant in reporting objectively, disinterestedly, and without any bias. Under this heading the following subjects are considered:

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False or Misleading Statements	Rule 5
Contingent Fees	Rule 9
Financial Interest in Client's Affairs	Rule 13
Auditor as Director	No formal A.I.A. rule, but see rule 7 of the N. Y. State Society of CPA's.
Occupations Incompatible with Public Accounting	Rule 4
Occupations Followed Simultaneously with Practice of Public Accounting	Rule 15
Commissions, Brokerage, and Fee Splitting	Rule 3
Forecasts	Rule 12

The next grouping has to do with the accountant's obligations toward his clients. It is impossible to practice accountancy without clients and so Mr. Carey rightfully observes that it is obviously desirable that the profession, as a whole, so conduct itself that prospective clients shall have implicit confidence in the competence and trustworthiness of its members. The rules discussed under this heading thus possess a dual purpose: to guide practitioners and to reassure those who engage them. They include the following subjects:

Confidential Relationship	Rule 16
"Professional Dignity"	No formal rule
Commissions, Brokerage, and Fee Splitting	Rule 3
Practice by Corporations	Rule 11
Use of Accountant's Name by Another	Rule 2
Certification of Statements Audited by Others	Rule 6

The last section of the book considers the problems growing out of the accountant's relations with his colleagues. These comprise the etiquette of the profession and are good examples of social rules, aimed to protect the interests of the group against the selfish or egoistic impulses of the individual. The topics here included are:

Advertising	Rule 10
Solicitation	Rule 7

Competitive Bidding	Rule 14
Offers to Employees of Other Accountants	Rule 8
Use of Professional Discretion with Firm Names	Rule 1
Miscellaneous Questions	No formal rules

Perhaps the best way to summarize the value of this book is to quote its concluding paragraph:

"Out of the traditional standards of proper behavior have grown the rule of professional conduct of all the professions. Through these rules the professions hope to provide a discipline which their members will voluntarily accept, and thereby win public esteem. This will increase the fortunes of the professions as a whole, but, even more important, the opportunities of their members to serve their community in a useful and honorable way."

The book should be required reading for all students of accounting and neophytes beginning practice. It will prove to be an invaluable reference guide to older practitioners whenever specific questions arise concerning their professional conduct. Mr. Carey deserves the plaudits of the profession for this useful and important compilation.

EMANUEL SAXE

C.P.A. Review (revised edition),

By Sidney G. Winter. Prentice-Hall Accounting Series; H. A. Finney, Editor. New York, PRENTICE-HALL, Inc., 1946. xxxi + 633 pages. \$6.00.

More than fifteen years have elapsed since the first edition of C.P.A. REVIEW was published. During that time much has taken place in connection with the refinement of accounting theory and the development of accounting and auditing practice. There has been a considerable departure from the accepted practices of the past, particularly in the field of financial statements, and an increased emphasis upon the development of standard and accepted practices in the fields in which a public accountant is engaged. Furthermore, increased attention has been accorded the field of governmental and institu-

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tional accounting; likewise, cost accounting has grown in importance principally, of course, as a result of the increased productivity resulting from the war effort.

The Certified Public Accountant examinations have reflected the changes in the theory and practice that have developed during the period mentioned. And Prof. Winter in this revision of his excellent work, whose first edition went through five printings, has given effect to this expansion of field and change of emphasis.

In a short foreword Professor Winter analyzes the development of the C.P.A. examination, and briefly suggests the methods of preparation for this examination and the manner in which a candidate should conduct himself while taking it.

In the body of the book, which is divided into eleven sections, he treats the following topics:

1. Partnerships
2. Corporations
3. Financial Statements
4. Auditing
5. Cost Accounting
6. Insolvencies, Receiverships, and Liquidations
7. Consolidations, Mergers and Holding Companies
8. Assets, Liabilities and Capital
9. Accounting for Estates and Trusts
10. Governmental and Institutional Accounting
11. Actuarial Science
12. Miscellaneous C.P.A. Problems

At the beginning of each section he lists the standard reference works which might be consulted by the student and, in the bibliography at the end of the volume, he provides a full description of all such references. Candidates preparing for the C.P.A. examination will find Professor Winter's book to be an excellent source of review in the fields indicated.

E. S.

Airport Accounts,

by Joseph M. Cunningham, C.P.A.
MUNICIPAL FINANCE OFFICES ASSOCIATION OF UNITED STATES AND CANADA; Chicago, Illinois. 1945. iii + 28 pages. \$1.25.

This manual presents a standard system of accounts for airports which is offered as being equally applicable to both commercial and governmental operations, and which may be used by either small or large units. In the former case, only the principal accounts indicated in the tabulation are recommended for use; in the case of the larger airports, the use of the subdivisions therein included is indicated in order to yield a maximum of accounting information.

The study begins with a statement of principles which govern the field. It continues with a presentation of a detailed classification of accounts, including both revenue and expense accounts and asset and liability accounts. It concludes with an explanation of the use of the accounts thus classified.

The work is clear, comprehensive and authoritative.

E. S.



OFFICIAL DECISIONS *and* RELEASES

HOUSE OF REPRESENTATIVES
79TH CONGRESS—2d Session
REPORT NO. 2713

RECONSTRUCTION FINANCE CORPORATION

JULY 31, 1946.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

MR. MANASCO, from the Committee on Expenditures in the Executive Departments, submitted the following

REPORT

The Committee on Expenditures in the Executive Departments, to whom was referred the letter of the Comptroller General of the United States to the Speaker, dated June 19, 1946, printed as House Document 674, submits the following report with reference to such letter and the matters connected therewith:

On June 17, 1946, the Director, Corporation Audits Division of the General Accounting Office addressed a letter to the Board of Directors of Reconstruction Finance Corporation stating that the Division had found such inadequacies and other deficiencies in the accounting function of the Corporation and its subsidiaries and affiliated corporations that it would be impossible to make a satisfactory audit of the Corporation's affairs for the year ended June 30, 1945, and that this might also prove true with respect to the year ended June 30, 1946.

Concurrently with the delivery of this letter to the Board of Directors of RFC, the Comptroller General transmitted copies to the Congress as an interim report under section 5 of the act of February 24, 1945 (59 Stat. 6). See House Document No. 674, Seventy-ninth Congress.

The Committee on Expenditures in the Executive Departments, to which this letter was referred, opened hearings on July 2, 1946. Mr. Frank H. Weitzel, Assistant to the Comptroller General, and Messrs. T. Coleman Andrews, CPA, Director; Howard W. Bordner, CPA, Deputy Director; and Theodore Herz, CPA, Assistant Director, of the Corporation Audits Division of the General Accounting Office appeared and testified on behalf of the Comptroller General. On July 10, 1946, Mr. Charles B. Henderson, Chairman of the Board of Directors, and Mr. Henry A. Mulligan, director and treasurer, of RFC, appeared with a number of officers and employees of RFC and testified on behalf of the Corporation. After full consideration, the committee finds as follows:

1. That the accounting system of RFC covering its nonlending activities is inadequate

and otherwise deficient, as reported by the Comptroller General. Notwithstanding their prepared statements, the officials of the Corporation, when questioned by the committee, made admissions which confirmed the findings and opinions of the auditors. They further admitted that they were months behind in their account keeping of nonlending activities.

2. That accounting is one of the most important responsibilities of management and that RFC thus far has failed to discharge this responsibility satisfactorily or to recognize its full extent. This failure undoubtedly was due in part to the exigencies of war, but this may not be accepted as full justification. The continuing lack of adequate accounting control of its war activities from their inception down to date may render the Corporation forever unable to give full financial account of some of these activities.

3. That a satisfactory audit of a corporation's affairs cannot be made unless the corporation's accounting is adequate, accurate, and up to date. It is the duty of auditors only to review complete accounting data and no part of their duty to undertake accomplishment of the accounting function or otherwise relieve management of its responsibility therefor. Adequacy of accounting implies the establishment of procedures that will assure timely, orderly, and accurate recording, in books of account, of all assets, liabilities, capital, income and expense, not merely cash receipts and disbursements, and timely preparation of statements from the accounts that show how the corporations' capital is being employed and afford the directors and managers of the corporations, and the Congress, a clear basis for operating and policy decisions. The committee recognizes that accounting is not the sole objective of administration, but it believes that the Congress has a right to expect the accounting of the Government's corporations to be equal to, if not better than, the best found in private corporations.

4. That the letter to the Board of Directors of RFC was framed with restraint and fairness and, as indicated by this letter as well as by those who appeared before the committee for the General Accounting Office, the attitude of that office toward the Corporation is one of objectivity and desire to be constructively helpful.

5. That the Comptroller General acted with propriety and in keeping with the requirements of the law in transmitting to the Congress immediately a copy of the letter of June 17, 1946, to the Board of Directors of RFC.

6. That RFC should accept the proffered aid of the auditors and their recommendations.

Official Decisions and Releases

The following inquiry made by one of our members, and the official reply thereto, are reproduced herewith because of their possible general applicability:

NATHANIEL FIELD
Certified Public Accountant
New York

August 30, 1946

Hon. Joseph D. Nunan, Jr.
Commissioner of Internal Revenue
Washington, D. C.

Dear Sir:

We have read the recent T.D. 5532, pertaining to the income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed April 16, 1945, and effective (for the purposes of United States income and excess profits taxes) for taxable years beginning on or after January 1, 1945.

We would greatly appreciate additional information or a clarification as to this tax convention, viz:

1. What is the status of the British Income Tax deducted on dividends or interest paid to residents of the United States?
2. Will taxpayers be permitted to claim credit for such taxes withheld from dividends and interest by the United Kingdom?
3. Can taxpayers claim such credit beginning with the year January 1, 1945?
4. Should taxpayers file Claims for Refund, covering the year 1945, covering taxes withheld by the United Kingdom from dividends and interest?

An early reply to the above will be greatly appreciated.

Respectfully yours,

NATHANIEL FIELD

TREASURY DEPARTMENT
Washington 25

Sept. 10, 1946

IT:P:T:2
DMB-6

Mr. Nathaniel Field
521 Fifth Avenue
New York, New York

Dear Mr. Field:

Reference is made to your letter of August 30, 1946, in which you ask some four questions relating to the application of the provisions of the United States-United Kingdom Tax Convention, proclaimed July 26, 1946, and effective as of January 1, 1945.

The provisions of Article VI with respect to dividends, insofar as applicable to your inquiry, are as follows:

ARTICLE VI

* * * * *

"(2) Dividends derived from sources within the United Kingdom by an individual who is (a) a resident of the United States, (b) subject to United States tax with respect to such dividends, and (c) not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom surtax."

* * * * *

It will be observed that the quoted paragraph exempts the dividends only from United Kingdom surtax. The United Kingdom does not impose its standard tax (currently at the rate of 45 percent) upon dividends. From the standpoint of the United States the United Kingdom imposes only surtax on dividends as such. The United Kingdom, however, does impose its standard tax upon earnings of the corporation out of which earnings dividends are ultimately paid. See *Biddle v. Com.* 302 U.S. 573 (1938). For the purposes, however, of the credit against the United States tax, the tax convention deems the United States shareholder in a United Kingdom corporation to have paid the United Kingdom standard tax which, in fact, has been paid, not by the shareholder but by the corporation paying the dividends. (Article XIII(1) United States-United Kingdom Income Tax Convention.) This privilege is conditioned, however, upon the shareholder including in his, or its, gross income the amount of the United Kingdom tax thus deemed to have been paid. Thus, if A, a United States resident, holds stock in the B Company, Limited, a United Kingdom corporation, and A's so-called gross dividends derived from his stock in 1946 is \$1,000.00, he actually receives only \$550.00 because the United Kingdom standard tax for that year is 45 percent. If A desires to claim a credit against his United States tax for the \$450.00 deemed to have been paid by him he must report in his gross income for 1946 the amount of \$1,000.00 and not the net amount of \$550.00 actually received by him.

There is no refund of United Kingdom tax with respect to dividends so far as concerns the standard rate of tax. The United States shareholder is deemed to have paid the United Kingdom standard tax only for the purposes of the credit for foreign tax as provided in Article XIII(1) of the Convention and not for the purpose of refund of any part of such tax.

The provisions of Article VII with respect to interest, insofar as applicable to your inquiry, are as follows:

ARTICLE VII

* * * * *

"(2) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such interest and not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom tax; but such exemption shall not apply to such interest paid by a corporation resident in the United Kingdom to a United States corporation controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation."

With respect to claiming credit for British taxes withheld on interest or other income, Article XIII of the Convention provides that subject to section 131 of the United States Internal Revenue Code as in effect on the first day of January, 1945, United Kingdom tax shall be allowed as a credit against United States tax. Accordingly, subject to the provisions of section 131 of the Internal Revenue Code, credit may be claimed for United Kingdom tax as of January 1, 1945.

The matter of securing refunds of British tax withheld is one coming within the jurisdiction of the British taxing authorities.

However, in order to bring the exemptions provided by the tax convention immediately into effect, the United Kingdom Board of Inland Revenue, in cooperation with this office, has devised a series of forms for use of individual residents of the United States, domestic corporations, and domestic custodians acting on behalf of residents of the United States and domestic corporations. Such forms provide for exemption from United Kingdom tax where the tax has not yet been collected and for refund of tax where such tax has already been collected. Form M1 (corporation) and Form M1 (individual) are the forms to be used where a claim is made by a United States corporation and a United States resident, respectively, to repayment of United Kingdom tax deducted from interest and certain other income, derived from sources in the United Kingdom. These and other necessary forms with respect to exemption from, or refund of, British tax, may be obtained from the collector of internal revenue, Second New York District, Custom House, New York 4, New York, or from the Board of Inland Revenue, Somerset House, London, W.C. 2, England.

Very truly yours

E. I. McLARNEY
Deputy Commissioner



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